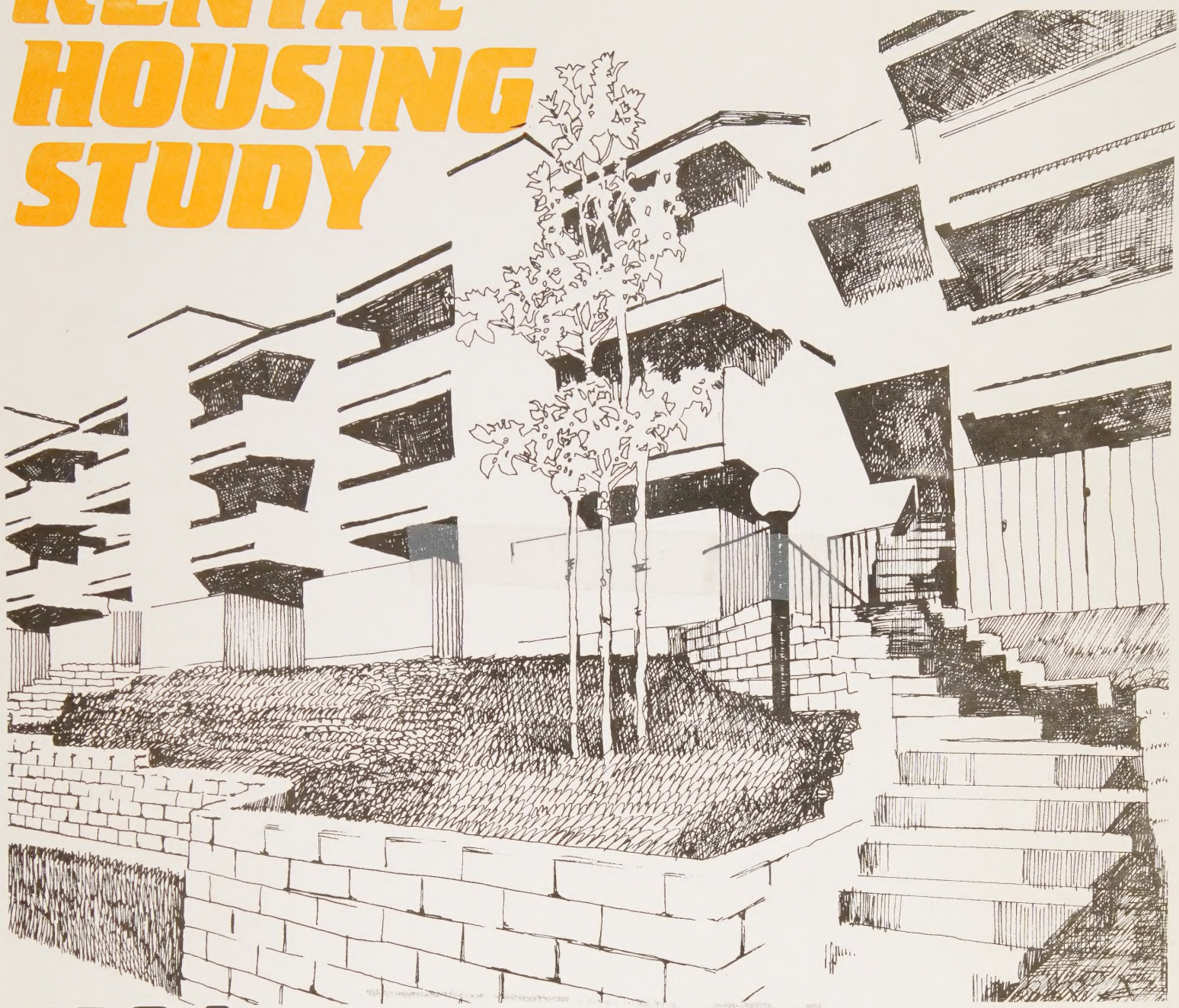


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RENTAL HOUSING STUDY



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HOUSING PRODUCTION AND
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HOUSING PRODUCTION AND PERFORMANCE UNDER
RENT STABILIZATION

Prepared by
Rent Stabilization Division
Community Development Department
City of Los Angeles

April 1985



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EXECUTIVE SUMMARY

Rent stabilization in Los Angeles has been implemented over the past six years in a housing market experiencing major changes due to larger market forces. These included major shifts in inflation and interest rates, changing demographic composition, continuing migration into the area, and changing rates of income growth. Some changes preceded rent stabilization, for example, the price inflation effects of the oil shocks in the 1970's. Others, such as the fall in inflation since 1982, have occurred while stabilization has been in place. Their effect has been to create a turbulent market environment.

This report analyzes the impacts of rent stabilization in the market, focusing especially on market performance, new construction of rental housing, maintenance and reinvestment. The essential point of departure of this analysis of impact is that rent stabilization in Los Angeles is a moderate system of regulation. Although debates on rent regulation often assume that its market impacts are everywhere good or bad, in fact those outcomes depend upon the form of regulation and the degree of stability with which it is administered.

Market Performance as reflected in vacancy rates, rent levels, mobility rates and density rates, indicates that the influence of rent stabilization has been generally moderate.

- o Vacancy rates for rental housing were low at the time of adoption of rent stabilization and have risen little in subsequent years. At this time, the estimated level of vacancies is between 1.5 and 3.5 percent, depending upon the source of measurement. This is well below generally accepted levels for good market functioning.
- o Vacancy rate impacts of rent stabilization are ambiguous. Vacancy rates in six nonrent stabilized comparison cities were also very low over the period 1978-1984, although they run about one-half percent higher than in Los Angeles. On this evidence, the continuing low level of vacancies in Los Angeles is more attributable to broad market forces than to rent stabilization.
- o Rent levels on average, have risen as rapidly in Los Angeles with rent stabilization as in the comparison cities without it. In 1984, the average contract rent in Los Angeles was about \$408 per month, an average annual increase of 10.8 percent since 1977. For the non-rent stabilized

cities, average rent was higher, \$422, but the equivalent average annual increase since 1977 was 11.1 percent.

- o Distribution of rent increases has varied significantly among household types, but most of the influence of rent stabilization has occurred through its effects on tenure. Households with tenure of more than six years, especially, have experienced lower average rates of increase than those in which turnover has been more frequent. Average gross rent-to-income ratios for the former actually fell from 28.5 percent to 26.7 percent from 1977 to 1984. This was largely the result of a lower average compound rate of increase in rents, 10.1 percent annually, as opposed to a 13.2 percent increase in average rents recorded by households with tenure length of one to two years.
- o Mobility rates have fallen since 1977 for rent stabilized and non-rent stabilized markets alike. Average years at the present residence rose by 54 percent in Los Angeles and 52.6 percent in the comparison cities. The proportion of households with 6 or more years of tenure, however, almost doubled in Los Angeles, from 17.7 percent to 34.1 percent. In contrast, in the comparison cities that proportion grew more slowly, from 13.8 percent to 22.9 percent. This difference is most likely an effect of rent stabilization.
- o Density rates have risen sharply throughout the Los Angeles region resulting in an increase in crowding. No effect of rent stabilization is detectable here, but the issue should be of concern for housing policy.

New Construction of rental housing has been profoundly affected by shifts in market forces before and since the adoption of rent stabilization. Although exempt from regulation, new construction appears to have been affected to a moderate degree by rent stabilization, but the influence has declined over time to the point where it is undetectable.

- o Total new construction of all multi-family housing including unsubsidized, subsidized and condominiums in Los Angeles fell sharply from a high of 12,307 units in 1978 to a low of 4,493 units in 1982. Since then, it has recovered strongly to a level of 12,103 units in 1984. The first year decline in 1978 was especially abrupt, 19.2 percent. The corresponding decline in the comparison cities began a year later, but was

slightly greater, 21.7 percent, suggesting that most of the observed shift was attributable to general market forces.

- o The composition of new construction has changed over the past ten years. In Los Angeles, non-subsidized rental housing fell from 77.3 percent of total multi-family construction in 1976 to a low of 26.8 percent in 1981. Since then, it has recovered to an 11 year high of 9,498 units, over 78 percent of the total in 1984. Condominium construction exhibits a reverse pattern and accounted for only 9.4 percent in 1984. Subsidized housing has increased in the 1980's, with a strong peak in 1983. The pattern in the non-rent stabilized cities is similar with the exception that rental housing has recovered more slowly than in Los Angeles.
- o The impact of rent stabilization on new construction is difficult to isolate from other market forces at work. Statistical analysis of Los Angeles and the comparison cities indicates that it has had some impact, but that its effect was greatest in the early years and has diminished over time as the market has recognized the stability of the regulatory system. This has powerful implications for policy with respect to changes in the rent stabilization system as they affect new construction.

Maintenance and Reinvestment are important for the conservation of the rental housing stock, a social resource that is not easily replaced. Both maintenance and reinvestment are very difficult to measure and data on them are quite limited.

- o Maintenance of the housing stock, is reflected in reported incidence of problems and levels of satisfaction of tenants in the survey. There appear to be some maintenance problems in the stock, but little effect of rent stabilization. Some 15.6 percent of respondents in 1984 reported problems, compared to 12.5 percent in 1977; for the comparison cities, the comparable increase was from 4.8 percent to 15.9 percent. The proportion of tenants satisfied with maintenance was also essentially identical inside and outside Los Angeles, ranging from a high of 80 percent satisfied with physical condition to a low of 70 percent satisfied with speed of repair. Only for tenants who had occupied their units less than one year or six or more years was there a greater

degree of dissatisfaction in Los Angeles than outside.

- Continuing maintenance of the stock appears to be due to the relatively favorable position of operating costs in relation to income from rents, upon which the capacity of owners to sustain maintenance ultimately depends. The reduction of tax expenses due to Proposition 13 has lowered operating costs, offsetting increases in other categories.
- Reinvestment in the housing stock is necessary for the intermittent replacement of large subsystems, and is also used to upgrade buildings in order to attract higher rent tenants. Provision is made in the Rent Stabilization Ordinance for rent increases to offset expenditures for replacement and some improvements, although protection of tenants from displacement is also a major objective.
- The Capital Improvements provision accounts for about 2,300 capital improvements per year with a value of some \$10 million per year. Annually, about 5 percent of the units in stock have been affected. It is estimated that less than 10 percent of total annual reinvestment in the stock has occurred through this mechanism.
- Distribution of capital improvements under the Capital Improvements program is weighted towards larger buildings. Buildings with 12 or more units accounted for 68 percent of reinvestment under the program, but comprise less than 40 percent of the rent stabilized stock. Small buildings are under-represented to a corresponding degree.
- Reinvestment outside the Capital Improvements program has been occurring. Both tenant and landlord surveys reported significant amounts of improvements since 1978. If rents rise sufficiently to sustain rates of return, then the incentives for normal reinvestment will continue to exist.

CHAPTER 1

INTRODUCTION

This report fulfills part of the mandate of the Los Angeles City Council and Mayor in an action taken November 14, 1983, authorizing a study of the Los Angeles housing market to be conducted under the direction of the General Manager of the City's Community Development Department (CDD). The study has been carried out by the Rent Stabilization Division of the CDD, with the assistance of a Steering Committee and outside consultants and contractors.

The City Council specified three broad target areas for the study:

- 1) A basis for an objective formula for adjusting the annual automatic rent increase permitted by the Rent Stabilization Ordinance.

- 2) Alternative methods of directing the benefits of the Rent Stabilization Ordinance to low income and senior citizen tenants.

- 3) Development of statistically reliable information on a range of housing market performance characteristics that were to include:

- o the range of contract rent in residential rental units;
- o an analysis of residential rental unit expenses, including operating expense and debt service;

- o vacancy rates;
- o density rates;
- o mobility rates;
- o tenant income levels;
- o reductions and additions to the residential rental housing stock;
- o deterioration and improvements to the residential rental housing stock.

Additional amendments to the Council action called for analysis of mobile home parks, rent-to-income ratios in relation to subsidy, and vacancy decontrol.

This report responds to the third element in the City's mandate, namely, the relationship between rent stabilization and housing market performance. It deals with three major groups of topics: overall indicators of housing market performance; the impact of rent stabilization on new construction of rental housing; and the impact of rent stabilization on maintenance and reinvestment in the rental housing stock.

RENT STABILIZATION AND THE LOS ANGELES HOUSING MARKET

Rent stabilization in the City of Los Angeles began in the fall of 1978 with a rent moratorium that was in effect until the Rent Stabilization Ordinance (RSO) was passed in the following year. Although amended in some respects, the Ordinance has remained unchanged in its essential features

until the present time. In studying its impacts, we may take the regulatory character of the system to be generally constant since its inception, with the proviso that there was a period at the outset when the system was being developed and learned by all its participants. This is important because the form of regulation is likely to have a substantial influence on its effects--a characteristic that is often forgotten in debates over rent stabilization.

Rent stabilization ordinances vary substantially in their level of regulation. In comparison with 11 other local rent stabilization ordinances now in force in California cities and counties (excepting those for mobile homes), the Los Angeles RSO is moderate in the degree of regulation that it implies. In contrast with relatively restrictive ordinances such as those in Berkeley or Santa Monica, Los Angeles permits rents to rise to market levels when a unit becomes vacant, although they are re-regulated thereafter. On the other hand, Los Angeles requires registration of all rental buildings and requires just cause for evictions, unlike cities such as Oakland where rent stabilization exists in a very moderate form.

Among California cities with rent stabilization, Los Angeles falls roughly in the middle in the degree of restrictiveness of its Ordinance. As noted above, the RSO permits vacancy decontrol of rents and allows for an annual automatic increase of 7 percent. It provides a mechanism for owners to request increases to ensure a just and

reasonable return, as is constitutionally necessary, and permits rent increases to offset the cost of capital improvements. On the other hand, unlike some more restrictive ordinances, Los Angeles does not exempt small owner occupied buildings from regulation. Except for single-family homes, units in buildings constructed since October, 1978, a small number of luxury units, and a few units that have been deregulated following substantial renovation, (luxury and substantial renovation exemptions amount to less than 1 percent of registered properties), all rentals are subject to the Ordinance.

The specific and unique character of the Los Angeles Rent Stabilization Ordinance is important when we consider the nature of its impacts on the market. The pattern of such impacts in general will depend on several factors. One is the nature of the Ordinance itself; in particular, the degree to which its provisions are in fact restrictive in the context of the market conditions. A second set of factors are in the market itself, especially those forces that may be working to render the Ordinance more or less restrictive; for example, large increases in demand due to migration. A third factor is simply time. Any regulation generates its own set of expectations and responses. These are learned as the regulatory structure develops its rules and procedures. In markets, regulations will, in general, become part of the perceived environment and their effects incorporated into the way that people do business. However,

this process takes time because the stability of any regulation that affects the outcome of long-term investments cannot be known immediately. Understanding the behavior of the market in response to a regulatory innovation such as rent stabilization requires attention to each of these concerns.

ORGANIZATION OF THE REPORT

This report comprises three chapters following the introduction. Chapter 2 examines a series of housing market indicators, following the City Council's request. After an initial discussion of the general forces that were affecting the Los Angeles housing market in the 1970's, we present short discussions of the behavior of several important indicators of performance. They include vacancy rates, rent levels, mobility rates, and density rates.

In Chapter 3, we take up the issue of the impact of rent stabilization on new construction of rental housing. For this purpose, data on new construction in Los Angeles in the period before and since the inception of rent stabilization is compared to similar information for a set of comparison cities that do not have rent stabilization. In order to investigate the question of the relative effect of rent stabilization in comparison to other factors, multivariate analysis is necessary.

Chapter 4 looks at the maintenance of housing and reinvestment by owners during the period of rent stabilization. Since maintenance is very difficult to measure it is necessary to use a variety of sources and indicators for this purpose. Reinvestment is examined principally through the medium of the capital improvement provision of the Ordinance, which allows us to see how much capital has been invested and for what purposes. Although this source represents only part of the total reinvestment in the housing stock, we can use it in combination with data from other sources to estimate behavior in a sector for which information is scarcely available.

CHAPTER 2

THE LOS ANGELES HOUSING MARKET: STRUCTURE AND CHANGE

The aim of this chapter is to provide an overview of the Los Angeles housing market and to show how it has changed or not in some key respects since rent stabilization has been in existence. It begins with a review of the larger situation of housing in the City and the metropolitan area during the decade of the 1970's. This is necessary in order to establish the variety of factors that were at work in the Los Angeles housing market, both contributing to and affecting the outcome of rent stabilization. The second part of the chapter discusses a series of specific indicators of housing market performance that were requested in the City Council's mandate for the housing study.

INFLUENCES ON DEMAND AND SUPPLY IN THE HOUSING MARKET

Rent stabilization did not occur in a vacuum, nor are its impacts worked out in a constant environment. Housing markets in most market economies are volatile and subject to many influences. The demand for housing and its supply, both for rental and ownership, are deeply affected by larger forces in the economy and society. Some of these factors are relatively easy to identify and trace. Others are obscure and not obvious at first sight. Although this report cannot provide a comprehensive analysis of the housing market in the Los Angeles region over the past

fifteen years, it is nonetheless important to give some sense of the way in which larger forces have shaped the market in which rent stabilization has evolved.

The performance of a housing market results from the interaction of forces affecting demand and supply. Among the factors that influence demand, changes in population and numbers of households, and shifts in income levels are generally accounted to be of critical importance.

Population growth and the formation of new households and families due to demographic changes lead to increases in the general demand for housing. If a region experiences rapid in-migration, or if its population in a given period contains large numbers of young adults who seek to establish their own living units, the demand for housing is likely to grow even if resources are limited. On the other hand, if incomes are rising, there will most likely be an increased demand for housing as existing households seek improved quarters and people who formerly shared with others are able to enter the market on their own behalf.

Demographic Influences on the Housing Market

Los Angeles and its metropolitan area clearly experienced significant demographic changes during the 1970's. Aggregate population grew from about 2.8 million people in the City in 1970, to almost 3 million in 1980, a gain of about 5 percent in the decade. By 1983, the population had risen to over 3.2 million. In comparison,

the Los Angeles-Long Beach SMSA grew from 4.2 million to 4.5 million in the decade, a gain of about 7 percent. In itself, such a rate of growth is not startling. It is much lower than the rate in earlier decades, and not among the highest in California. However, in common with other parts of the U.S., Los Angeles has also been experiencing declining household sizes. Mean household size in the City fell from 2.68 persons in 1970 to 2.55 in 1980. As a result, the total number of households grew in the decade by over 10 percent, from 1.03 million to 1.14 million. Under ordinary circumstances, supply in a housing market should be able to handle growth rates of this magnitude without difficulty. Yet in Los Angeles, as in other parts of California, the latter part of the decade was characterized by rising rents and falling vacancy rates, indicators of pressure in the housing market, especially on lower priced housing.

One source of the problem may have been the pattern of demographic growth over the decade. Intercensal figures are not entirely reliable, but there is some evidence that the rate of growth was not uniform over the ten year period. It is estimated that the City's population fell by about 3 percent between 1970 and 1975. Natural increase did not change significantly over these years. On the other hand, migration and the rate at which the young adults entered the housing market may have varied considerably.

Migration, especially from abroad, has probably been the largest single component of change in the Los Angeles housing market in recent years. It has been estimated that in the absence of migration, the population of the County would have fallen by some 200,000 rather than rising by 450,000 during the decade. For the City, it is likely that the role of migration was, if anything, more important. The data suggest that in the first half of the decade, net migration was negative. In the years from 1977 to 1980, it turned positive and probably exceeded 200,000 overall. The composition of migrants to the City is not known precisely. For the County, the greatest number are from Latin America and Asia. They are relatively poor and typified by large families. Although some number of them would be able to afford relatively expensive housing, most would be competing for rentals at the lower end of the market.

The second half of the decade of the 1970's was not only notable for the spurt in foreign migration into Southern California. It was also a time of sharp inflation in price levels in general, and of housing prices in particular. This pattern occurred at the same time that substantial numbers of young adults, the so-called "baby boom" generation were entering the housing market. Although not affluent, these groups could bid effectively for housing in the rental market, especially against tenants on fixed incomes who were experiencing the effects of price inflation that were beginning to become evident.

It is difficult to document the scale of this demographic effect precisely owing to changes in definitions between 1970 and 1980. Some indicators suggest that it did occur. The percentage of family (i.e. conventional) households in the City fell from 67 percent in 1970 to 61 percent in 1980. At the same time, the percentage of the population in the 18 to 64 age bracket rose from 60 percent to 64 percent, while the proportion of the eligible population that was married fell from 57 percent to 46 percent. While much of this change is consistent with the type of migration to the City that was occurring, it also suggests that the composition of the newly forming households was also changing.

Demographic shifts, which seem so evident at first sight, are more complex when examined carefully. Nonetheless, it is clear that substantial demographic changes were occurring in Los Angeles during this period and that they affected the rental housing market.

Income Changes and Rental Housing

Incomes are the other major influence on the demand for housing that must be examined in this contextual analysis. The role of shifts in income is less clear than that of demographic changes. Overall, there was no dramatic increase in income in the City or the region during the decade of the 1970's. While median household income more than doubled in current dollars between 1970 and 1980, from

\$7,511 to \$15,735, its real value in constant dollars after inflation grew by only 3 percent in the decade.

For renters, median real income fell by over 9 percent between 1970 and 1980, a substantial drop. This figure must be interpreted with caution, for during the decade the effect of inflation on income tax brackets was such as to cause a major shift in the tax advantages of home ownership. Accordingly, substantial numbers of people who would have rented in 1970, had moved to ownership by the end of the decade. Many of these would be families moving to suburban locations. Nonetheless, the proportion of renter occupied units in the total stock rose during the decade by just under one percent, to 60 percent. Evidently, the rental stock was being occupied overall by a relatively lower income set of households.

The implications of falling real income of tenants during the decade of the 1980's, are not dissimilar to those of the demographic shifts discussed earlier. In general, they would tend to increase pressure at the lower end of the housing stock, especially in submarkets that were threatened by gentrification, the movement into an area of a population group of significantly higher income and housing purchasing power. For tenants on fixed incomes, such a situation would present them with no option but to move in a market characterized by uncertainty. Through the 1970's, then, overall demand increased at a slow pace. But there is

evidence to suggest that the rate of demand growth was uneven over the decade, especially because of variations in migration which surged in the later years. Pressure on lower income households by the 1970's was also generated by a rising rate of inflation which especially affected those on fixed incomes. They were ill-prepared to deal with problems in housing supply that would change the competition for their housing and neighborhoods.

Influences on the Supply of Rental Housing

Because new construction is a major element of this report, the discussion of influences on supply in this context will be brief. In common with other areas, Los Angeles in the 1970's and early 1980's was subject to fluctuations in market conditions for housing supply and production that had not been equalled since the 1930's. Housing is the sector perhaps most subject to larger economic changes, since it relies on credit to a degree equaled by few others. The economic shocks of the decade, particularly those caused by huge increases in energy prices, affected the industry sharply in Los Angeles as in the U.S. as a whole. Historically high interest rates changed the cost structure for new construction and acquisition of rental housing, while rising energy costs affected operating costs.

From the slump of 1974, housing production recovered to a peak in 1978, only to collapse again in 1982 to its lowest

level since World War II. At the same time, the attractiveness of the existing stock to different segments of the market was also changing. To the young adults of the "baby boom," the lower priced and locationally cheaper housing offered by formerly stable neighborhoods in Los Angeles became a magnet in the 1970's. For low income migrants, the same was true, though they could afford only lower rent areas. Inflation also resulted in astonishing gains in value for single-family housing as people sought to insulate their earnings from tax bracket creep. As average incomes in specific areas rose, so did competition for their rental housing. Within the City, some areas became "hot" and their long-term renter residents faced the prospect of being forced to move in a market where their limited incomes permitted no comparable choice.

In this context of inflationary uncertainty and market pressure from the demand side, the normally expected cycles in housing supply tended to be exacerbated, with consequent effects on tenants. In such a situation, the impact of the events following the passage of Proposition 13 that led to the decision to implement rent stabilization seems understandable.

HOUSING MARKET PERFORMANCE INDICATORS

Housing markets are dynamic and constantly changing. Complicated economic and social processes are at work and changes in a single isolated factor rarely results in dramatic shifts in the overall market. However, the interaction of several factors can lead to significant market changes. Distinguishing between the effects of several factors, or establishing conclusively which of many factors is the primary cause of a market change, is a difficult and at times an impossible task.

Rent stabilization has been an added factor in the Los Angeles housing market since 1978. But other influences have been at work as well: changing populations with differing housing needs and life styles; changing demands for home ownership in response to increased property costs and rising interest rates; and the fluctuating and unprecedently high inflation rate, which affected family incomes, consumer spending, the cost of constructing rental housing, and alternative investment options. All of these have affected rental housing, some of them with more direct influence on market performance than others.

In this section we will examine the impact of change on a series of important indicators specified in the Los Angeles City Council's mandate. We will report findings on vacancy rates, rent levels, mobility, and density rates. Each of these indicators reflects an aspect of the

functioning of the housing market for tenants and owners. Together, they provide a sense of how the market has behaved during the period of rent stabilization.

Vacancy Rates

Vacancy rates are widely accepted indicators of the economic efficiency of the rental housing industry. A 5% vacancy rate is a United States Department of Housing and Urban Development benchmark¹ used in rental housing analysis as a threshold above which the forces of supply and demand can interact efficiently.

Some vacancies are inevitable and necessary in rental housing. Usually, some time between tenancies is needed by a landlord for routine cleaning and maintenance. A unit may not rent immediately at the asked-for price and the landlord may find it more profitable to hold out for higher rent, even if this policy leaves a unit unrented for a period of time.

Vacancy rates are commonly used by builders and financiers of rental housing as a rule-of-thumb for indicating if a city or a part of a city is a potentially profitable location for constructing additional rental apartments. A low vacancy rate and high rents encourage construction. High vacancy rates and low rents in an area are disincentives to construction. In general, vacancy rates are the most universally employed indicator of market pressure and it is for this reason that in recent years

federal government agencies have attempted to measure them for local areas.

In the light of their importance, it is a paradox that obtaining accurate and up-to-date information on vacancies is so difficult. Individual property owners know what units are unrented in their own buildings, but there is no organization of landlords, and no public agency, that collects and provides vacancy rate data. Decision makers in both the private and public sectors traditionally rely on indirect indicators for vacancy rates, such as the decennial census, annual reports from the Federal Home Loan Bank Board (FHLBB), the annual Income/Expense Analysis of the Institute of Real Estate Management (IREM), or surrogate indicators, such as idle meter statistics from local utility companies.

Each of these sources measures vacancies differently, since each has its own reasons for collecting the data. Nor is there a standardized definition of "Vacancy." While the U.S. Census considers a vacancy as a rental unit that is unrented and available for rent², landlords may think a unit where tenants have merely given their notice to quit is also effectively vacant insofar as it can be shown to prospective tenants. It is not surprising that when several sources report vacancies, the vacancy rates are often quite dissimilar.

Conflicting vacancy rates can sometimes be reconciled. At other times it may be necessary to accept the methodological differences between sources and rely on changes in rates as reported by a single source. In this analysis of vacancy rates during the period of rent stabilization, we will utilize five such sources.

In the Los Angeles area, the following sources supply data which can be used to calculate vacancy rates:

1) The United States Census Bureau reports vacancy rates as part of the national decennial census. The major problem with census data is the ten-year lag time between each census. While the census may not be a particularly useful tool to policy makers who need a more continuing flow of vacancy information, it can be used to verify other sources which are published more frequently.

Census data (see Exhibits 2.1 and 2.2) indicate that the rental vacancy rate dropped substantially in both Los Angeles and in the six comparison cities between 1970 and 1980. The vacancy rate fell by 29.4% in Los Angeles, slightly more than in the six other cities (-24.6%). According to the census, by 1980 it was 3.9%. In the same decade the total rental housing stock increased in both Los Angeles and the six adjacent cities, but rental housing rose at a faster rate in Los Angeles (9.7%) than in the six cities (+6.1%).

EXHIBIT 2.1

1970 Vacancy Data Reported by the Census Bureau (Year-Round Housing Units) ³

City	Renter Occupied Units	Vacant and for Rent	Total Rental Inventory	Rental Vacancy Rate
Burbank	16,534	883	17,417	5.07%
Glendale	31,397	1,286	32,683	3.93
Inglewood	23,475	1,174	24,649	4.76
Long Beach	80,136	5,090	85,226	5.97
Pasadena	25,170	1,525	26,695	5.71
Torrance	18,400	1,099	19,499	5.64
6 city total	195,112	11,057	206,169	5.36
Los Angeles	607,573	35,734	643,307	5.55

Source: 1970 Census of Housing, V.1, Housing Characteristics for States, Cities, and Counties, Part 6, California, Table 8.

EXHIBIT 2.2

1980 Vacancy Data Reported by the Census Bureau (Year-Round Housing Units)

City	Renter Occupied Units	Vacant and for Rent	Total Rental Inventory	Rental Vacancy Rate
Burbank	17,416	586	18,002	3.26%
Glendale	34,023	1,105	35,128	3.15
Inglewood	24,252	845	25,097	3.37
Long Beach	86,591	4,496	91,087	4.94
Pasadena	25,562	942	26,504	3.55
Torrance	21,963	867	22,830	3.80
6 city total	209,807	8,841	218,648	4.04
Los Angeles	677,855	27,662	705,517	3.92

Source: 1980 Census of Population and Housing, Census Tracts Los Angeles-Long Beach SMSA, Section 3, Table H-1.

2) The Los Angeles Department of Water and Power (DWP) is a city-owned and operated public utility which issues monthly reports containing idle meter statistics for both single family residences and multiple unit buildings in the City of Los Angeles.

DWP's vacancy rate estimates are lower than those of the census. For multi-family buildings, the rate for 1980 was just over 3 percent. (See Exhibits 2.3-2.5). This data allows us to examine the changes in vacancy rates since 1977, before the adoption of rent stabilization. From 1977 through 1978, vacancy rates fell. Subsequently, they rose through 1983 but have fallen again in 1984. Single family vacancies are lower, since they are not generally for rent. However, they have been falling throughout the period. The range of variation in the multi-family vacancy rates is quite small, about 1 percent in eight years. The picture that emerges here is one of low level equilibrium. How much of that is attributable to rent stabilization cannot be estimated, but the rates for single family buildings suggest that larger market forces are also at work.

Exhibit 2.5 compares the DWP and census estimates for 1980. It should be noted that the estimates of total numbers of vacant units are lower than the difference between the totals for all units, and the numbers for single and multiple family units vary greatly. This suggests that

EXHIBIT 2.3

DWP Vacancy Rates 1977-1984
(March of each calendar year)⁴

Year	Single Family			Multiples		
	Meters	Vacant	Percent Idle	Meters	Vacant	Percent Idle
1977	668,194	11,672	1.75	335,671	9,399	2.80
1978	674,167	10,810	1.60	341,821	8,059	2.36
1979	684,349	9,499	1.39	344,030	8,423	2.45
1980	670,321	9,113	1.36	365,495	11,358	3.11
1981	666,186	8,623	1.29	378,247	13,127	3.47
1982	549,897	5,617	1.02	503,748	18,663	3.70
1983	543,240	5,816	1.07	518,383	19,782	3.82
1984	508,218	4,650	0.91	540,969	17,440	3.22

Sources: April DWP monthly reports: RP 90.7 (multiples)
Quarterly DWP reports: RP 91.A (singles)

EXHIBIT 2.4

DWP Multi-family and Single-family Vacancy Rates,
1977-1984

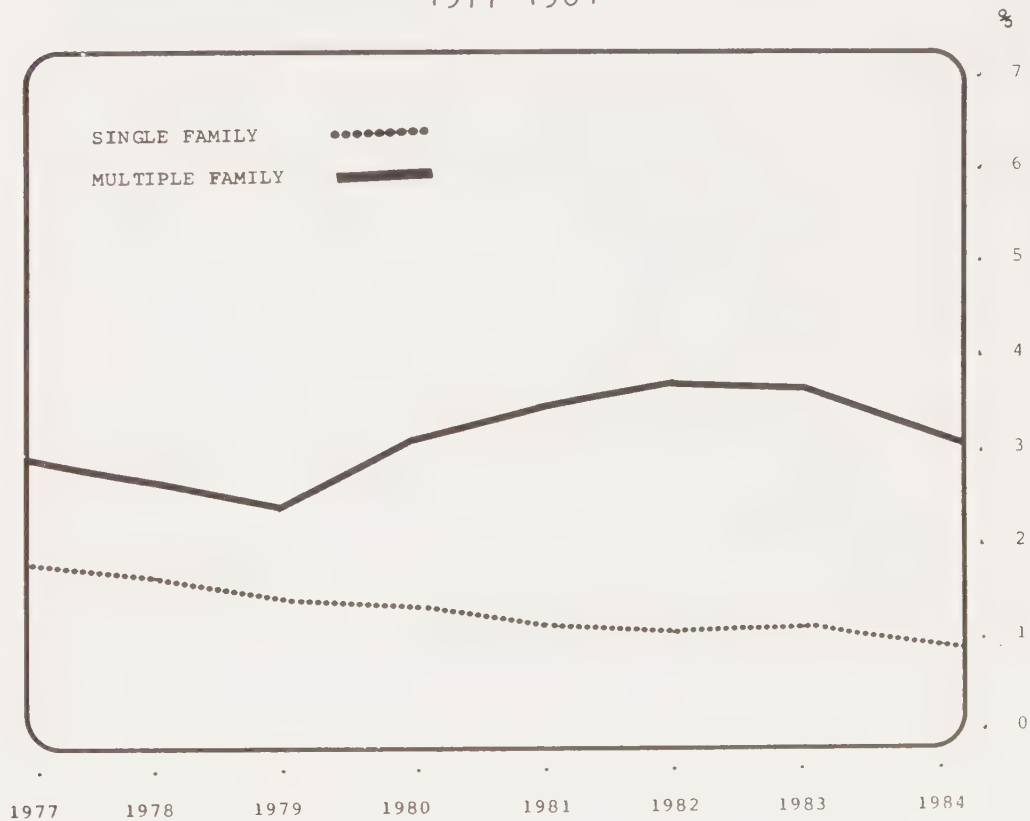


EXHIBIT 2.5

1980 DWP and U.S. Census Vacancy Rates Compared (Both Census and DWP data for March, 1980)

Types of Housing Units	DWP	Census
All Housing Units	1,035,816	1,171,162
occupied units	1,015,345	1,135,230
vacant units	20,471	35,932
vacancy rate	1.98%	3.07%
Single family units	670,321	564,683
occupied units	661,208	553,939
vacant units	9,113	10,744
vacancy rate	1.36%	1.90%
Multiple units	365,495	606,479
occupied units	354,137	581,291
vacant units	11,358	25,188
vacancy rate	3.11%	4.15%

Sources: 1980 Census of Housing, Metropolitan Housing Characteristics, Los Angeles-Long Beach SMSA, Section 2, Tables 8 and 12; DWP reports RP 91.A Quarterly and RP 90.7 monthly

small variations in vacancy rates should not be accorded too much significance.

3) The Southern California Gas Company (SCG) provides gas for cooking, heating and air-conditioning to a large percentage of, but not all, apartments in the City of Los Angeles . SCG also services many nearby cities in southern California. Like DWP, SCG reports on the total number of meters and the number of idle meters. For December 1984, SCG reported 454,789 individual gas meters located in the City of Los Angeles compared to 594,039 DWP electric meters in the same service area.

Despite the fact that SCG serves both Los Angeles and nearby cities, enabling comparisons of vacancies inside and outside the City which cannot be done with DWP vacancy rates, the SCG idle meter count is not as useful a vacancy measuring device as the DWP count. As can be seen in Exhibit 2.6, the SCG vacancy rate is substantially lower than the DWP vacancy rate. This difference is believed to stem from the data gathering and reporting methods of the two utilities, rather than from any actual vacancy rate difference. An analysis of the reasons for these vacancy rate differences are discussed in Appendix 3.E.

4) The Federal Home Loan Bank Board (FHLBB) of San Francisco annually publishes the most widely used report on vacancy rates of California cities. FHLBB data have some

EXHIBIT 2.6

Southern California Gas Company Multi-family Vacancy Data Compared to DWP Multi-family Vacancy Data (March of each year)

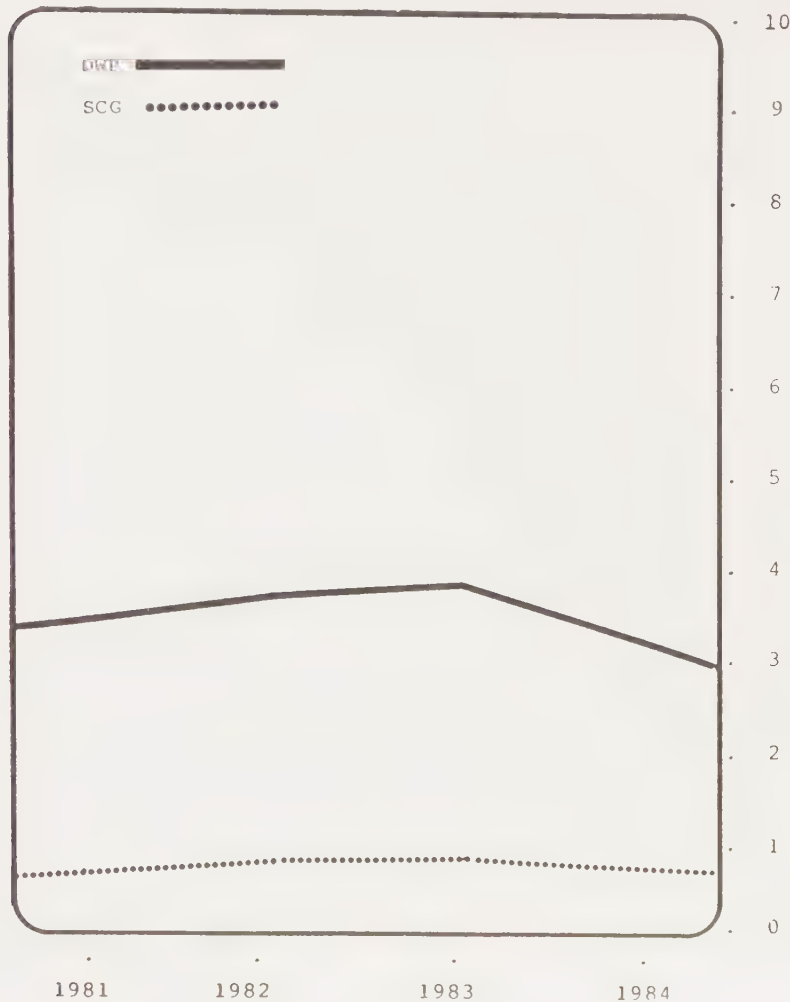
Year	SCG Meters	Number Idle	Percent Idle	DWP Meters	Number Idle	Percent Idle
1981	431,385	3,047	0.71	378,247	13,127	3.47
1982	437,484	3,500	0.80	503,748	18,663	3.70
1983	443,699	3,789	0.85	518,383	19,782	3.82
1984	449,777	3,316	0.74	540,969	17,440	3.22

Sources: April DWP Reports RP90.7, March SCG Reports CB-IDLE

EXHIBIT 2.7

Graph of DWP/SCG Vacancy Rates, 1981-1984

MULTI-FAMILY UNITS 1981 - 1984 (MARCH OF EACH YEAR) %



advantages over DWP data. FHLBB reported statistics for apartments include master-metered buildings, while the DWP data do not. FHLBB also reports on vacancies in mobile home parks and units under construction.

The FHLBB vacancy rates for apartments are significantly lower than those from DWP (Exhibit 2.8 and 2.9). Appendix 3.E, contains an analysis of the FHLBB data collecting and the reasons for differences between these data sources.

FHLBB data can be used to compare the changes in vacancy rates in Los Angeles with those in the six nearby cities used for comparison purposes throughout this study. Exhibit 2.10 and 2.11 traces the Los Angeles and the combined 6-city multiple vacancy rates from 1978 through 1984.

With the exception of 1980, when the 6-city vacancy rate took a sharp drop, the Los Angeles vacancy rate has run slightly less than 1% below the 6-city rate, and the changes over time have been approximately the same. The higher rate in the comparison cities is consistent with a hypothesis of an impact of rent stabilization. However, more significant are the consistently low values of both sets of rates and the small range of fluctuation. The close paralleling of the vacancy rates demonstrates that the greater Los Angeles housing market is a single market and that the forces of

EXHIBIT 2.8

FHLBB and DWP Multiple Vacancy Rates Compared for Los Angeles: 5 1978-1984

Year	FHLBB				DWP		
	Number of units	Number Vacant	Percent Vacant		Number of meters	Number Idle	Percent Idle
1978	511,797	10,534	2.06		341,821	8,059	2.36
1979	521,358	8,947	1.72		346,148	9,410	2.72
1980	547,420	10,504	1.92		366,879	11,710	3.19
1981	557,597	11,811	2.12		380,170	13,880	3.65
1982	562,234	12,174	2.17		503,748	18,663	3.70
1983	570,788	9,888	1.73		518,989	19,621	3.78
1984	575,224	9,007	1.57		556,819	18,969	3.41

Sources: FHLBB surveys, 1978-1984 (adjusted)⁶
 April DWP Reports RP 90.7, 1978-1984;
 FHLBB Surveys 1978-1984 (adjusted to include all
 Zip codes within of the City of Los Angeles)

EXHIBIT 2.9

Graph of FHLBB/DWP Vacancy Rates, 1978-1984

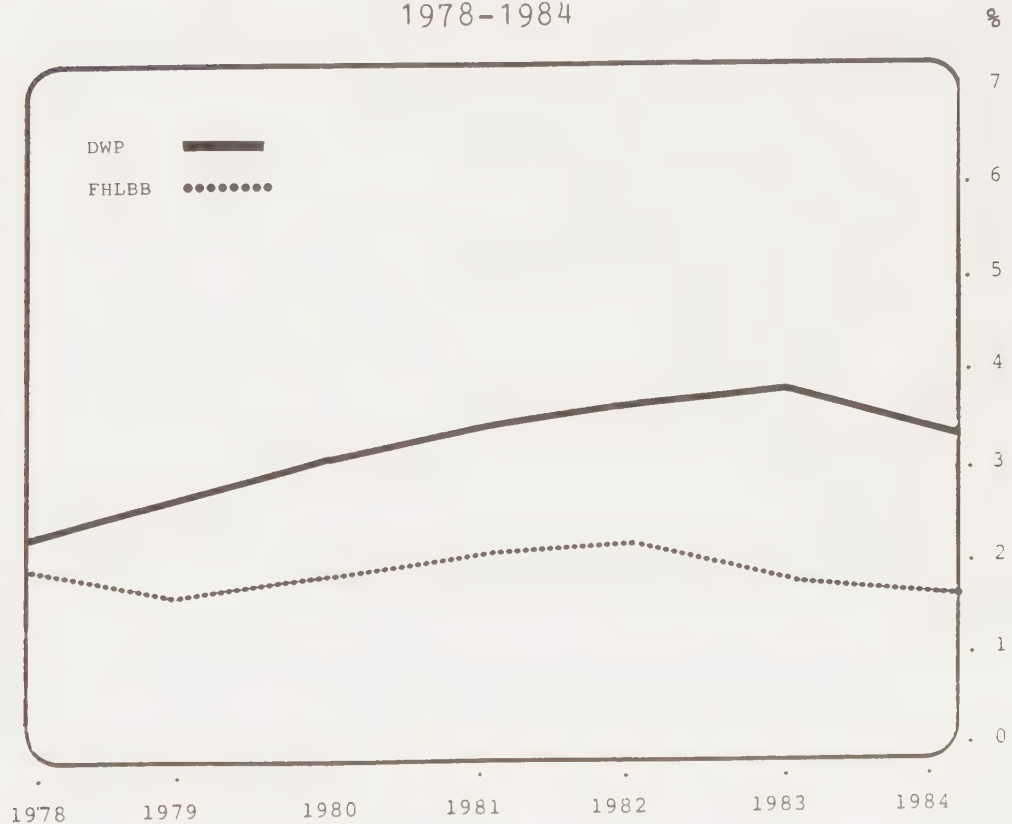


EXHIBIT 2.10

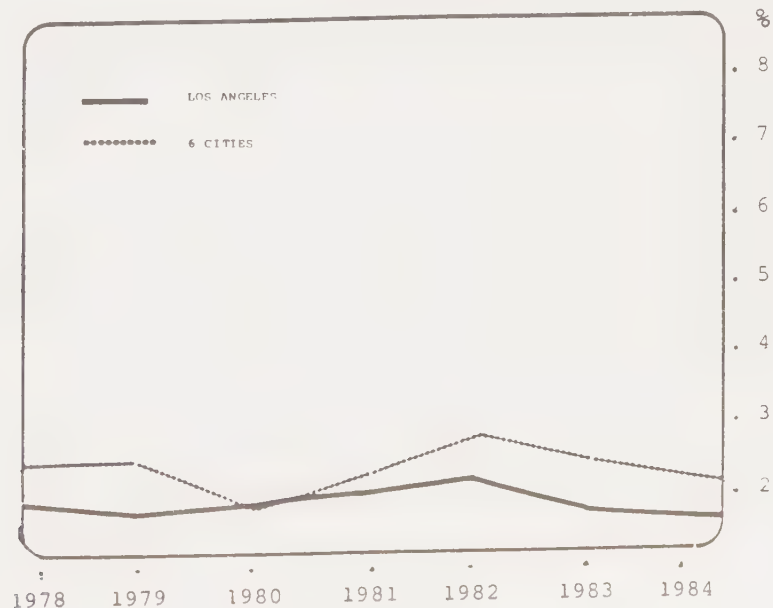
FHLBB Multi-family Vacancy Rates Los Angeles and 6 Adjacent Cities 1978-1984

Year	City	Units	Vacant	% Vacant
1978	Los Angeles	511,797	10,534	2.06
	6 cities	171,776	4,296	2.50
1979	Los Angeles	521,358	8,947	1.72
	6 cities	170,992	4,325	2.53
1980	Los Angeles	547,420	10,504	1.92
	6 cities	179,024	3,354	1.87
1981	Los Angeles	557,597	11,811	2.12
	6 cities	179,580	4,246	2.36
1982	Los Angeles	562,234	12,174	2.17
	6 cities	181,665	5,219	2.87
1983	Los Angeles	570,788	9,888	1.73
	6 cities	183,733	4,708	2.56
1984	Los Angeles	575,224	9,007	1.57
	6 cities	184,000	4,024	2.19

Source: FHLB surveys 1978-1984 adjusted ⁷

EXHIBIT 2.11

Graph of FHLBB: Los Angeles and Six Adjacent Cities, 1978-1984



supply and demand work in the same directions irrespective of city boundaries.

5) The Institute of Real Estate Management (IREM) publishes a vacancy rate in its annual income/expense analysis of its members' apartment buildings. See Exhibit 2.12 and 2.13. The advantage of the IREM data is that it can indirectly measure the effect of real vacancies on landlord profitability. The Gross Possible Total Income category in the IREM reports includes the rental of all units at an annual rate of 100% occupancy. The reporting IREM members then calculate the actual rent collected in comparison to the theoretical rent that would have been collected had there been no vacancies. From this the vacancy rate is derived. While this can be a useful tool for property managers in comparing their rental rate policies and their effect on rental income, the IREM data has a number of difficulties in its use for policies relating to rent regulation in the City of Los Angeles. These problems are detailed in Appendix 3.E. The IREM estimated vacancy rate has run about one percentage point above DWP and two points above the FHLBB rate. There is a modest upward trend since 1978, but the range of variation is quite small. No major variation is visible over the time period.

EXHIBIT 2.12

Los Angeles IREM and DWP Multi-family Vacancy Rates 1978 - 1983 (DWP data represents annual averages)

	1978	1979	1980	1981	1982	1983
IREM	3.7%	3.6%	3.9%	3.8%	4.3%	4.5%
DWP	2.6%	2.8%	3.4%	3.7%	3.9%	3.7%

Sources: IREM annual Income/Expense Analysis 1978-1983;
DWP reports RP9 0.7, annual averages 1978-1983

EXHIBIT 2.13

Graph of Los Angeles IREM and DWP Multi-family Vacancy Rates 1978-1983



Although the definitions of vacancy and the means of measurement vary greatly, the alternative sources of information about vacancy rates do give a picture that is consistent in many respects. The measures hint at a pattern of falling vacancy rates in the years immediately after the implementation of rent stabilization. The decline was limited by the fact that the level of vacancies was so low to begin with, and it cannot be solely attributed to rent stabilization, since pressure on the market had, in good part, contributed to the movement for rent stabilization in the preceeding years. The period 1978-1979 was a time of high demand in the housing market generally under the influence of rising incomes and inflation. By 1980-1981, vacancy rates had begun to rise again, presumably as a side effect of the serious economic recession. With the 1983-84 economic recovery, vacancy rates have fallen once more, dipping below their 1978 levels.

The role of rent stabilization in this pattern of change is not clear. Parallel movements of the rates in Los Angeles and the comparison cities suggest that the influence of larger market forces has been dominant. Los Angeles' vacancy rate has consistently run about one percent below that of the comparison cities, which may be due in part to rent stabilization. However, the lack of vacancy rate data before 1978 makes this supposition impossible to verify.

There are some differences between the behavior of the Los Angeles and comparison cities vacancy rates that do suggest some effect in the early years of rent stabilization. In particular, vacancies in Los Angeles fell faster in the first two years and rose more slowly in the recession years than was the case in the comparison cities. In contrast, during the last three years, rates have generally moved together for the two groups. This pattern is consistent with the possibility that the major impacts of rent stabilization on the market occurred early on and have tended to diminish subsequently.

Rent Levels

Closely related to vacancy rates are trends in rent levels. As the availability of rental housing declines, rent levels will increase with the growing demand in the absence of regulation. This element reports Los Angeles rent levels in comparison to rent levels in the selected areas outside the City (Long Beach, Pasadena, Torrance, Glendale, Inglewood, and Burbank).

The most extensive information on rent levels has been developed as part of the survey of tenants and is reported in detail in the HRS&A report. We will therefore only deal with the main results of that survey here and point to its significance as an indicator of market behavior.

EXHIBIT 2.14

AVERAGE CONTRACT RENTS

LOS ANGELES & SIX ADJACENT CITIES

1977 & 1984

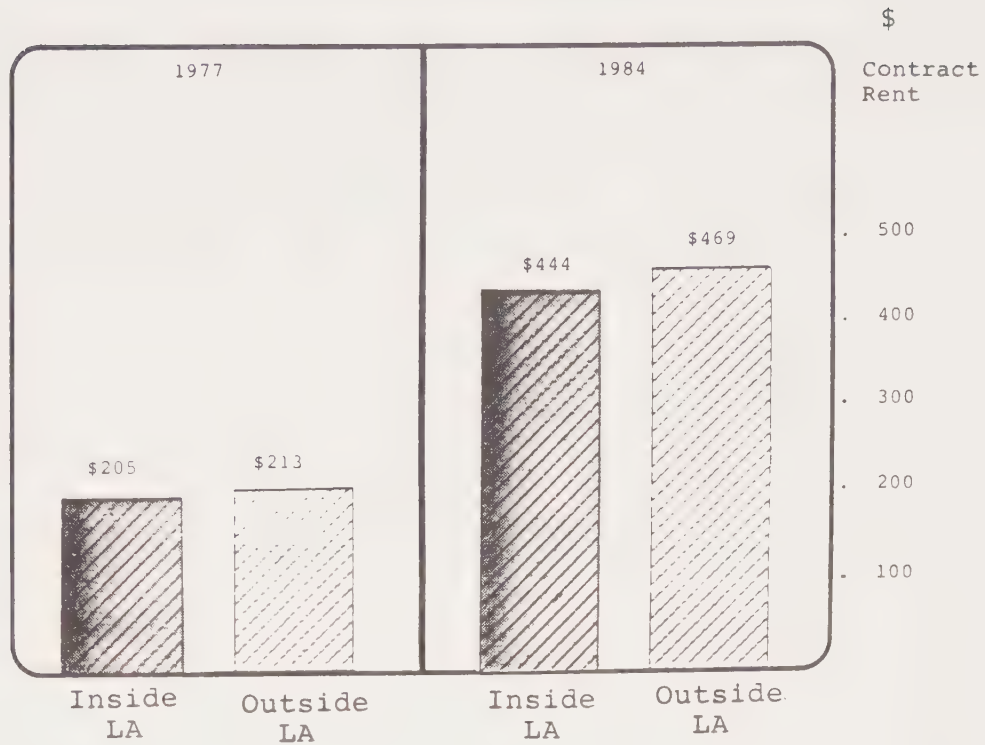
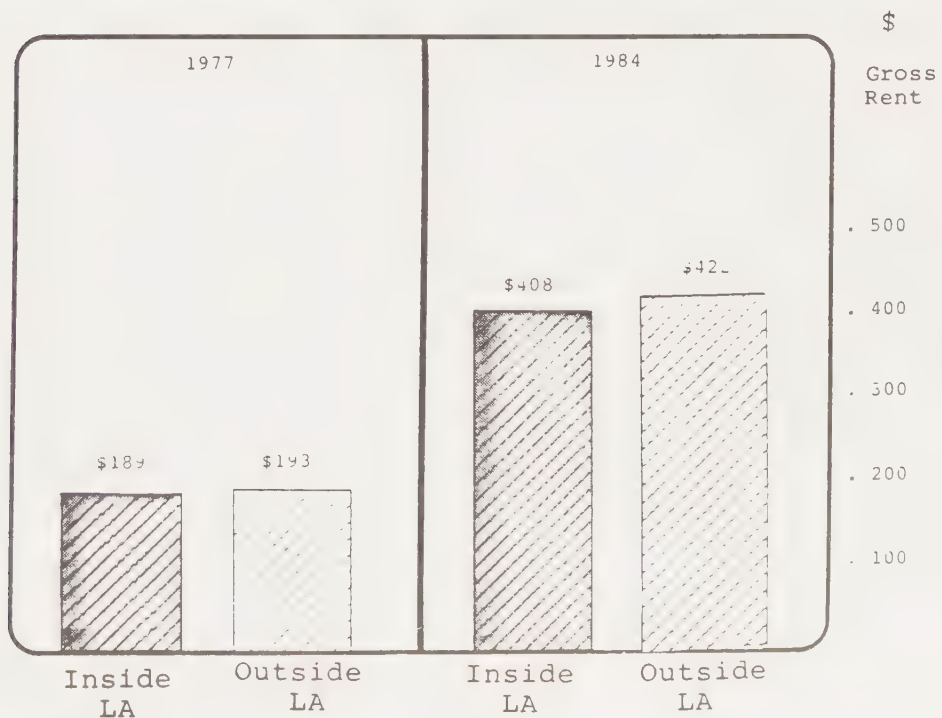


EXHIBIT 2.15

AVERAGE GROSS RENTS

LOS ANGELES & SIX ADJACENT CITIES

1977 & 1984



The average contract rent in Los Angeles increased from \$189 in 1977 to \$408 in 1984, an increase of approximately 10.8 percent per year compounded. Outside Los Angeles in the selected cities, the rents averaged \$193 in 1977 and \$422 in 1984, which is about the same rate, 11.0 percent. Gross rents exhibited an almost identical pattern.

Exhibits 2.14 and 2.15 indicate that average Los Angeles rent levels are comparable to rent levels in surrounding non-rent stabilized areas and that they have increased, in the aggregate, by similar proportions over the seven year period.

The aggregate rent changes mask a considerable amount of variation. For example, in Los Angeles average gross rents paid by households with heads over age 62 increased from \$194 to \$379, between 1977 and 1984. This is a compound growth rate of about 10 percent. In contrast, the growth rate of average rents for households with heads under age 30 was about 12.2 percent annually. It should be borne in mind that these averages include both scheduled rent increases and those generated by the effect of vacancy decontrol.

Conversely, average rents of lower income households (i.e., those in the \$10,000-20,000 income range) increased by about 9.1 percent annually, while for households in the \$30,000-40,000 income range, average rent grew by about 7.5 percent.

Finally, rents vary with length of tenure. For tenants with a tenure length of one to two years, the compound rate of increase in average rents was over 13.2 percent between 1977 and 1984. In contrast, those who had tenure length of more than six years showed a compound increase of about 10.1 percent.

In summary, rents increased more rapidly for those who were younger, lower income, or characterized by shorter tenure, and more slowly for their converse. These shifts are quite substantial and had the effect of changing rent income ratios for the affected groups. Although these shifts cannot be entirely attributed to the implementation of rent stabilization, the likelihood that it has contributed to them is considerable.

Mobility Rates

Mobility rates also provide an indication of economic efficiency in the housing market. Mobility rates are typically measured by the number of years that households have lived in their dwelling units. Under the Los Angeles rent stabilization system, mobility or "length of tenure" is closely related to rent levels as a result of the vacancy decontrol-recontrol provision.

Mobility rates have substantially declined throughout the metropolitan area since 1977. Los Angeles tenants are considerably less mobile than they had been in the recent

past. However, similar mobility trends were observed in the surrounding areas.

From 1977 to 1984 the average length of tenure of Los Angeles tenants rose by about two years. (See Exhibit 2.16 and 2.17) However, this average simplifies what is in reality a dramatic shift in the distribution of mobility rates in yearly increments. In 1984, approximately 45 percent of Los Angeles households had moved within the previous 2 years compared to 67 percent in 1977 - a 22 percent decrease. Nevertheless, the rental mobility rate in Los Angeles remains higher than the national averages.

Not all of this change in mobility can be ascribed to rent stabilization. Similar shifts occurred in the comparison cities, where 53 percent of households in 1984 had moved within the previous two years as compared to 71 percent in 1977. The decline was greater in Los Angeles, with a 22 percent decrease in contrast with an 18 percent fall in the comparison cities, but the difference is not large.

On the other hand, Los Angeles households remaining in-place for six years or more increased from 18 percent in 1977 to 34% in 1984 - a 16 percent increase among Los Angeles tenants, compared to a 9% increase in surrounding areas. Given the relatively higher benefits from rent

EXHIBIT 2.16

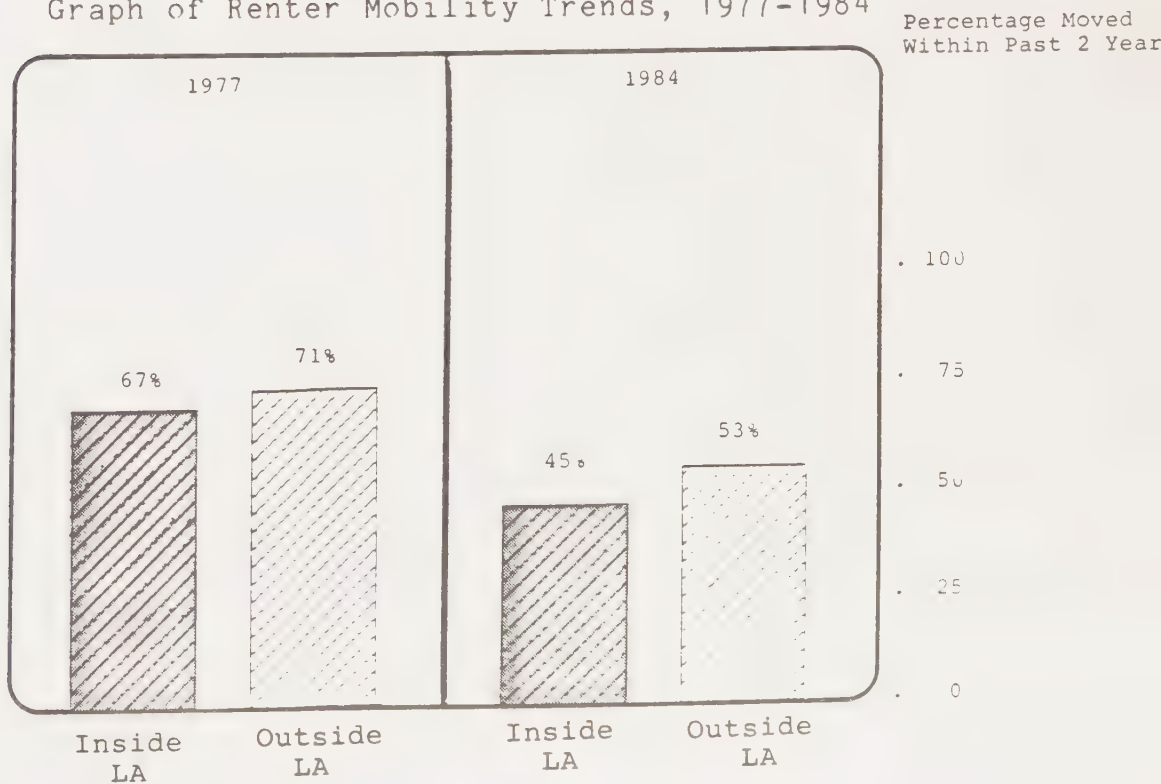
Renter Mobility Trends, 1977-1984

<u>Cities</u>	<u>Los Angeles</u>		<u>Comparison</u>	
	<u>1977</u>	<u>1984</u>	<u>1977</u>	<u>1984</u>
Average Number of Years at Residence	3.56	5.49	2.91	4.44
Distribution by Length of Tenure				
Less Than One Year	31.2%	21.4%	33.9%	24.0%
1-2 Years	35.6	23.5	37.6	29.1
3-5 Years	15.6	21.0	14.7	24.0
Over 6 Years	17.7	34.1	13.8	22.9
	----	----	----	----
Total	100.0%	100.0%	100.0%	100.0%

Source: 1977 American Housing Survey, 1984 Tenant Survey

EXHIBIT 2.17

Graph of Renter Mobility Trends, 1977-1984



stabilization that accrue to tenants with lengthy tenure, this shift does seem to reflect its influence.

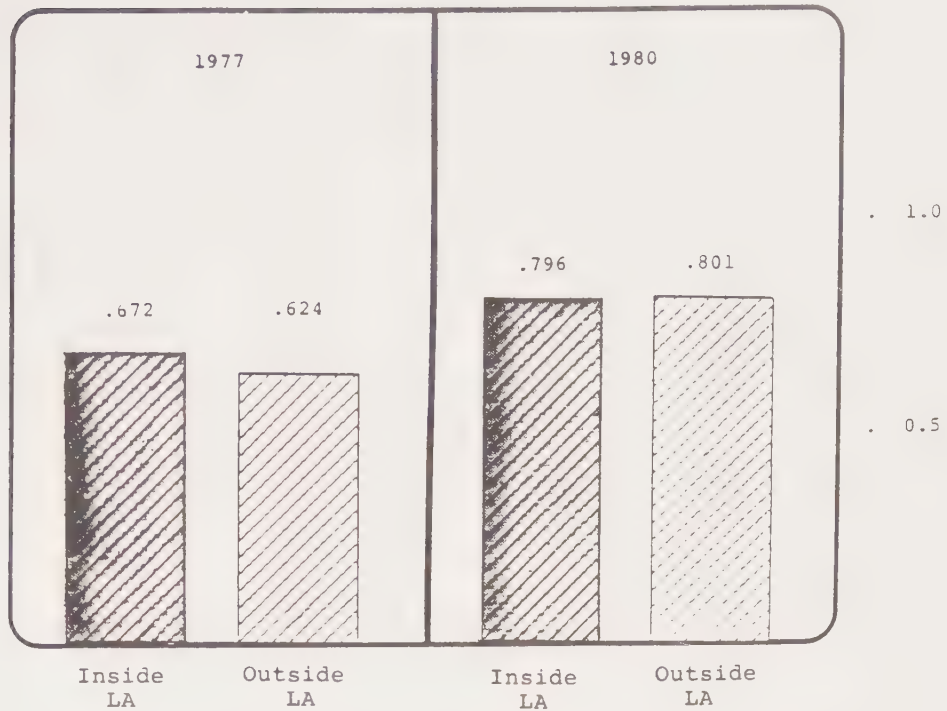
The averages conceal substantial variation among groups in the population. While the mobility of every group declined between 1977 - 1984, the greatest shifts appear to be among the elderly. The percentage of elderly renters in Los Angeles in-place for six years or more increased from 46 percent in 1977 to 67 percent in 1984 - a 21 percent increase. Similar trends among other groups were observed both in Los Angeles and in surrounding areas.

In general, both Los Angeles and the comparison cities have experienced declining residential mobility in the past decade. In good part, this behavior results from the larger forces that have affected the region's housing market as a whole. The causes of the larger change are not entirely understood. They may be due partly to the generally low rental vacancy rates in the region, which would tend to discourage movement. They may also be due to changes in demographic structure. As households age, they tend to move less, and the proportion of young households has been declining.

Nonetheless, the specific changes in all elements of the population do suggest that rent stabilization has contributed to the decline in mobility. As the premium associated with longevity of tenure in a rent stabilized apartment grows, so does the implicit cost of moving. In an

EXHIBIT 2.18

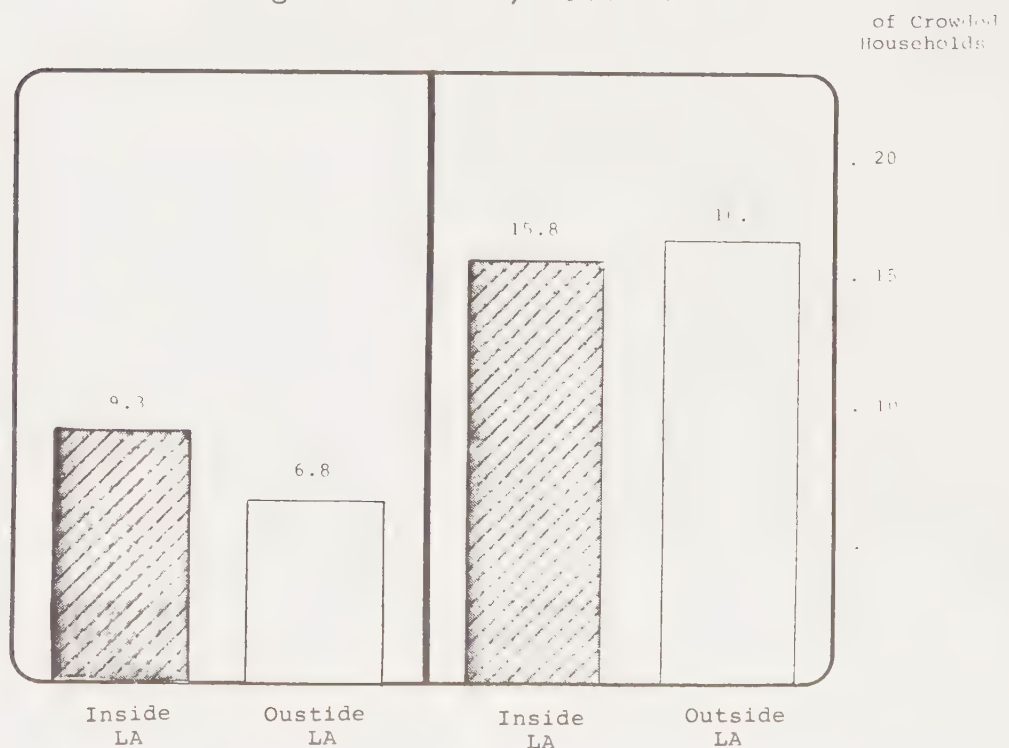
Average Persons Per Room, 1977-1984



Source: 1977 American Housing Survey, 1984 Tenant Survey

EXHIBIT 2.19

Crowding Conditions, 1977-1984⁸



Source: 1977 American Housing Survey, 1984 Tenant Survey

environment of low vacancy rates, the costs of searching for alternative housing rise, adding to the attractiveness of staying in place.

Density Rates

Density rates are defined here by the number of persons per room and are used as a measurement of crowding (see Exhibit 2.18). Density rates are indicators of households "doubling up" due to affordability, availability, and other market factors. However, they also reflect demographic influences, especially the prevalence of families with children.

The decade of the 1970's saw a marked increase in housing density in the region. Despite a continuing fall in household size, the proportion of households living at densities of more than one person per room rose substantially between 1970 and 1980. This trend seems to be related to a tendency toward formation of very small relatively affluent households on the one hand, and the immigration to the region of large numbers of relatively poor households with children on the other. Both the U.S. Census and our survey data from this study confirm the trend.

Similar increases have occurred in the density rates of Los Angeles and non-rent stabilized areas. Between 1977 and 1984 the density rates of Los Angeles households and households in surrounding areas increased by approximately

10 percent, a figure comparable to trends throughout the metropolitan area.

The condition of overcrowding is more difficult to judge. It is generally considered to mean anything over one person per room. This standard has been applied in the calculations of crowding conditions presented in this Study. Exhibit 2.19 charts the percentage of households in 1977 and 1984 which exceeded this standard.⁸ It is notable that the relative increase in crowding in the comparison cities far exceeds that in Los Angeles.

CONCLUSION

The four indicators of market performance received here (vacancy rates, rent levels, mobility and density) reveal only limited systematic effects of rent stabilization on the Los Angeles rental housing market. Because the degree of regulation is moderate, this might be expected. The nature of the impact is primarily distributive. That is, rent stabilization affects the market more in its outcomes for different groups than in its behavior on the average.

Overall, it is clear that the rental housing market remains under pressure. Vacancy rates are low both in Los Angeles and in comparable non-regulated cities. If there is a loosening tendency, it is small and scarcely larger than the range of error in the data. Rents in Los Angeles, on average, have risen about as much as those in

the non-regulated cities. However, the impact of rent stabilization is visible in the lower rents paid by tenants who have not moved since the inception of rent stabilization. In general mobility in the region has declined, with a somewhat greater decline in Los Angeles that is consistent with the effect of longevity of tenure on stabilized rents. Densities have increased quite sharply, both in the City and outside. This aspect of market performance does not appear to be related to rent stabilization, but it is important for the housing welfare of the City.

FOOTNOTES

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- 1 Urban Housing Market Analysis, HUD, December 1969, p. 29.
 - 2 1980 Census of Housing, Metropolitan Housing Characteristics, Los Angeles-Long Beach SMSA, Section 2, Appendix B, p.3.
 - 3 1970 Census did not include unrented vacant mobile homes.
 - 4 1984 Single Family DWP data are from the June, not the April report. DWP April 1984 report was not available.
 - 5 DWP averages for same months in which FHLBB surveys were taken.
 - 6 FHLBB Los Angeles data as published have been expanded to include all Zip codes located within the Los Angeles City limits.
 - 7 *ibid.*
 - 8 The standards of crowding used are as follows: 1 person in an efficiency or single unit; 2 persons in a one bedroom; 3-4 persons in a two bedroom; 5-6 persons in a three bedroom; and; 7+ in a four bedroom.

CHAPTER 3

RENT STABILIZATION AND NEW CONSTRUCTION IN LOS ANGELES

One of the most difficult issues to deal with in relation to rent stabilization is the question of its impact on the construction and provision of new rental housing. This chapter explores the question as it applies to the experience of the Los Angeles ordinance. For this purpose, the chapter will consist of four main parts:

- o A brief discussion of the new construction issue in rent stabilization.
- o Description of new construction of rental housing in Los Angeles and a number of comparison cities in the region.
- o Analysis of the impact of rent stabilization on production of new rental housing.
- o Discussion of alternative policy directions to ensure an adequate flow of new construction in the future.

The regulatory context of the analysis is established by the Rent Stabilization Ordinance in L.A.M.C. 151.01 M6, which exempts from the Ordinance housing accommodations located in a structure for which a certificate of occupancy was first issued after October 1, 1978. Thus, rental units

built since that date are not subject to rent stabilization and their rent levels are established in the market.

Despite this exemption, the question of the impact of rent stabilization on investment in new housing construction has been raised in Los Angeles as in other cities where similar exemptions have been enacted. At issue is the influence of the existence of rent stabilization on investment perceptions, especially the possibility of future extension of regulation to new construction.

NEW CONSTRUCTION AS AN ISSUE IN RENT STABILIZATION

Few issues in rent control have generated as much debate as the question of whether and how the implementation of regulation affects developers' decisions to build new rental housing. Most economists have argued that the existence of regulation will affect expectations, increase perceived risk, and generally have the effect of depressing investment in new construction. Proponents of control have argued that there is little evidence that such behavior occurs on any significant scale in practice. Rather, they see investment decisions as being overwhelmingly determined by other factors in the market, notably expectations about the demand for housing and the cost of constructing it. Although this debate has continued for many years, there have been few carefully designed studies to test the issue. Even if there were such studies to draw upon, it seems likely that the impact would vary from place to place with

variations in the form of regulation and in market conditions. Thus, it is important that the issue be carefully assessed in the particular circumstances of the Los Angeles housing market over the period during which rent stabilization has been in place.

The importance of this issue lies in its implications for the effectiveness of rent stabilization as a strategy for dealing with the problem of rising rents. Under typical assumptions about the operations of the market, unusually high rent increases of the type that often precipitate rent stabilization measures would result in higher than normal returns for owners of rental buildings. In such a circumstance, it would become profitable to supply additional housing, and new suppliers should enter the market. Thus, a period of high rents should be followed by new construction and increased supply that result in increased competition and lower rents. If developers tend to overreact, then a boom-bust phenomenon may be observed in the housing market, with periods of high rents being followed by times in which rent levels increase only very slowly or even fall. Such a phenomenon is not uncommon in housing markets under pressure. An example is Houston, where rents have fallen substantially in the past two to three years and occupancy premiums for new tenants are quite common.

Opponents of rent stabilization have argued that by interfering in this process, regulation prevents the market from responding to demand by increasing supply. Once in place, stabilization would have the effect of inhibiting the kind of market response needed to make it unnecessary. Thus, as policy, this type of regulation would be a short-term palliative but a long-term problem. In response to this argument, proponents of stabilization have argued that new construction in such a situation does not alleviate housing pressures for those at the lower end of the market, since new housing would be outside their price range. In fact, the effect might be more negative if such new housing required demolition of older, low-rent stock.

Arguments such as these are asserted as general propositions rather than rooted in the circumstances of a specific situation. In order to assess their validity for a particular case, it is necessary to establish the facts, that is, to determine the actual levels of new construction that have occurred in the context of rent stabilization. It is equally necessary to analyze the information carefully so as to avoid imputing to rent stabilization effects that are really caused by something else. In the case of housing, this is especially important because development decisions are subject to a broad range of influences that change over time.

NEW CONSTRUCTION OF RENTAL HOUSING IN LOS ANGELES

How has new construction of rental housing in Los Angeles changed over the past decade? At first sight, this seems like a simple question that can be resolved simply by consulting the City's records. In fact, it is anything but obvious for a number of reasons, mainly to do with the ways in which housing is defined and recorded. Before discussing the data on levels of new construction, the nature of that data should be made clear.

Definitions and Data in New Construction

Two key definitional problems must be addressed in any attempt to measure the amount of new rental housing constructed by the market in any given period of time. First, how may rental, as opposed to other types of housing, be distinguished within the recording system? Second, how shall we distinguish rental housing that results solely from market investment decisions, as opposed to rental housing that is produced with some form of governmental subsidy? An accurate count of the amount of rental housing produced depends on successfully answering these questions.

When a building is proposed, its purpose is recorded, for example, residential or commercial, and a building permit issued if all requirements are met. Whether the form of tenure for the occupants is to be ownership or rental in the case of residential buildings is not always clear from

City records. (See Appendix 3.D.) In the past, it was possible, nonetheless, to infer how much new construction would be for rental because single-family housing was almost universally built for owner occupancy, while multi-family structures were almost always for rent. With the rise of multi-family condominium buildings in the 1970's, this distinction blurred. However, most cities moved quickly to generate data on condominium construction. Nevertheless, the rise of this new form of housing in California makes estimation of the production of rental units complicated. Although built for individual ownership, many condominiums are in fact rented, either because the developer is unable to market them effectively, or because there is a tax advantage to be gained from subdivision of the property at the outset, renting for several years, and then converting to condominium status when the market is appropriate. In addition, individual condominium owners may choose to rent out their units. Such rentals are generally equivalent to rentals of existing single-family units and are not relevant to the question of new multi-family construction per se. Although it is not always easy to find data on condominiums, and harder still to assess what portion of them are available for rent, accurate accounting of new construction of rental housing requires that this effort be made. For further discussion of this issue see Appendix 3.D on new construction methodology.

The second definitional problem in the measurement of rental housing construction concerns sources of funding. In order to assess the impacts of rent stabilization on the market, it is important that subsidized housing be distinguished from housing built by developers in response to their assessment of market factors alone. By subsidized, we mean all housing constructed with direct or indirect public sector financial assistance. During the period under consideration 1974-1984, the nature and quantity of subsidized housing in Los Angeles and its surrounding cities changed substantially. Throughout the period, federal housing programs were under pressure, and by its end the direct subsidy programs such as Section 8 had been replaced in good part by local initiatives using tax exempt mortgage revenue bonds. At the same time, the amount of subsidized housing that was built varied from year to year and city to city. Accurate measurement of rental housing developed by the market, therefore, requires an accounting of that part of production built with some form of subsidy.

Development of rental housing construction data to reflect these concerns takes substantial care and effort. The procedures employed in the study for constructing the necessary data series are described in Appendix 3.D.

Rental Housing Construction in Los Angeles, 1974-1984

The first step in analysis of the role and impact of rent stabilization on new construction of rental housing is

to review the actual levels of construction over the period in which regulation occurred. The Exhibits below present this data for Los Angeles and six comparison cities from 1974 through 1984. The six comparison cities were selected to allow simple comparisons between Los Angeles and communities in which rent regulation did not exist throughout the period. They also form part of the basis for the more complex analysis of the impact of rent stabilization discussed in the following section of this chapter. The cities comprise the following: Burbank, Glendale, Inglewood, Long Beach, Pasadena, and Torrance. No city in the region alone can begin to compare with Los Angeles in size or diversity, but these comparison cities do reflect much of the diversity of Los Angeles when taken in the aggregate. Like parts of Los Angeles, some are substantially built up, others are relatively open to development. They vary in their demographic, ethnic, and economic makeup, although in aggregate they have a somewhat lower proportion of minorities and higher incomes than does Los Angeles. Together, they form a useful benchmark against which rental construction data can be compared.

Exhibit 3.1 shows total multi-family new units built in Los Angeles and the comparison cities from 1974 through 1984. In general, we will take 1979 as the year in which rent stabilization was effectively introduced. A moratorium on rent increases was instituted on October 1, 1978 and the

Ordinance instituting rent stabilization became operative on May 1, 1979.

The cyclical nature of construction of new housing is clearly evident in the data. From the recession of 1974-1975, production rose to a peak in the late 1970's, fell sharply during the serious recession of 1981-1982 and recovered strongly in the final two years. The pattern for the comparison cities is similar, with the exception that production peaked in 1979 rather than in 1978. There was a falloff in new construction in Los Angeles versus the comparison cities in 1979, but the recovery in 1983-1984 has been stronger in the city. On the basis of the aggregate

EXHIBIT 3.1

Total New Construction of All Types of Multi-family Housing, 1974-1984

Year	Los Angeles	Comparison Cities
1974	6855	1534
1975	5081	862
1976	10398	1305
1977	11806	1105
1978	12307	1971
1979	9950	2734
1980	8877	2141
1981	6878	1392
1982	4493	967
1983	8201	2819
1984	12103	3076
Total	96949	19906

Source: Rent Stabilization Division new construction analysis. See Appendix 3.D.

data alone, then, the picture seems mixed; not an unreasonable result in view of the variety and complexity of factors that affected the housing market in these years.

In Exhibits 3.2-3.5, aggregate new multi-family construction is broken down into its component elements: non-subsidized housing, subsidized housing, and condominiums. Evidently, the pattern of construction has varied quite considerably across the categories over the years. Three features stand out. The first is the shift away from unsubsidized rental to condominiums that occurred both in Los Angeles and in the comparison cities in the middle of the period. For Los Angeles, the change seems to have happened earlier, between 1978 and 1981. In the comparison cities, the shift came between 1979 and 1983. The scale of the move towards condominiums is shown in the high proportions of total multi-family construction that they comprised in those years, peaking at 66 percent in Los Angeles and over 80 percent in the comparison cities. The second striking change is the recovery of nonsubsidized rental construction in the past two years. By 1984, this category accounted for over 80 percent of new multi-family construction in Los Angeles and close to 60 percent in the comparison cities. For both Los Angeles and the comparison cities, production stood at its highest level in over a decade. The third important feature of the period is the considerable increase in the share of Los Angeles' total new

EXHIBIT 3.2

Composition of New Construction in Los Angeles

	Unsubsidized	Subsidized	Condominiums	Total Units
1974	3969	394	2492	6855
1975	3752	244	1085	5081
1976	8035	898	1465	10398
1977	7568	795	3443	11806
1978	6476	1495	4336	12307
1979	4140	707	5103	9950
1980	2491	476	5910	8877
1981	1843	1055	3980	6878
1982	1607	1621	1265	4493
1983	4353	2559	1289	8201
1984	9498	1465	1140	12103
Total	53732	11709	31508	96949

Percentage Distribution

1974	58.0	5.7	36.4	100.0
1975	73.8	4.8	21.4	100.0
1976	77.3	8.6	14.1	100.0
1977	64.1	6.7	29.2	100.0
1978	52.6	12.1	35.2	100.0
1979	41.6	7.1	51.3	100.0
1980	28.1	5.4	66.6	100.0
1981	26.8	15.3	57.9	100.0
1982	35.8	36.1	28.2	100.0
1983	51.3	33.5	15.2	100.0
1984	78.5	12.1	9.4	100.0
Total	55.3	12.3	32.4	100.0

Source: Rent Stabilization Division new construction analysis. See Appendix 3.D.

EXHIBIT 3.3

Graph of the Composition of New Construction in Los Angeles

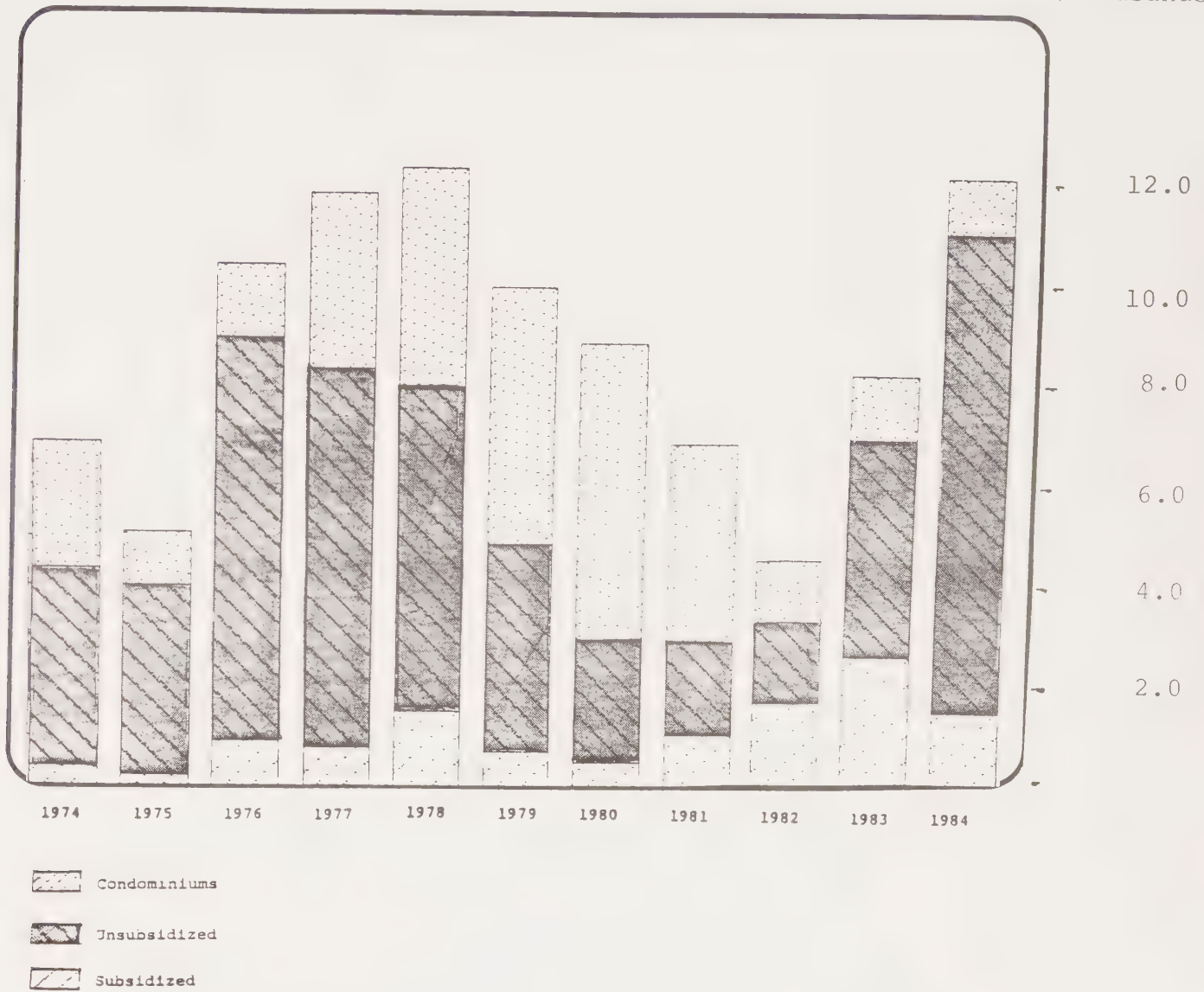
Numbers
of
Permits
(thousands)

EXHIBIT 3.4

Composition of New Construction in Comparison Cities

	Unsubsidized	Subsidized	Condominiums	Total Units
1974	919	169	446	1534
1975	621	78	163	862
1976	834	93	378	1305
1977	811	50	244	1105
1978	1323	324	324	1971
1979	1214	256	1264	2734
1980	217	37	1887	2141
1981	326	12	1054	1392
1982	306	101	560	967
1983	678	943	1198	2819
1984	1766	131	1179	3076
Total	9015	2194	8697	19906

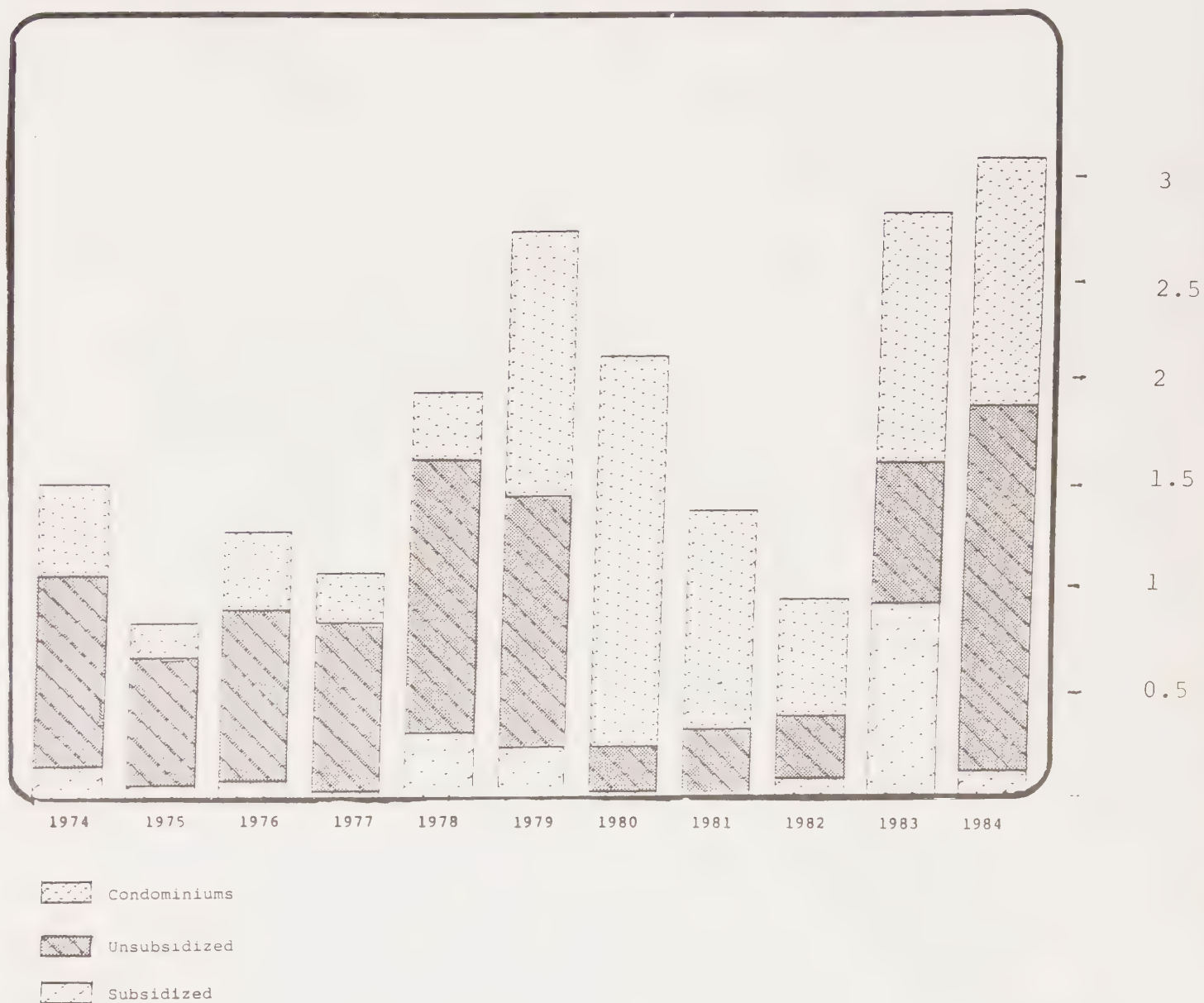
Percentage Distribution

1974	59.9	11.0	29.1	100.0
1975	72.0	9.0	18.9	100.0
1976	63.9	7.1	29.0	100.0
1977	73.4	4.5	22.0	100.0
1978	67.1	16.4	16.4	100.0
1979	44.4	9.4	46.2	100.0
1980	10.1	1.7	88.1	100.0
1981	23.4	0.9	75.7	100.0
1982	5.2	10.4	57.9	100.0
1983	24.1	33.5	42.5	100.0
1984	57.4	4.3	38.3	100.0
Total	45.3	11.0	43.7	100.0

Source: Rent Stabilization Division new construction analysis. See Appendix 3.D.

EXHIBIT 3.5

Graph of New Construction in Comparison Cities, 1974-1984

Numbers
of
Permits
(thousands)

multi-family construction accounted for by subsidized housing during the past four years. At a maximum, this share reached 36 percent in 1982. Clearly, the public sector has been active in response to the housing problems of the City.

The degree of variability among the components of new construction is rather greater than the variation in the total. To some extent, increases in one type of production have offset decreases in others. This was especially the case in Los Angeles, where all three moved simultaneously in the same direction in only two of the ten periods of change, as opposed to five times in the case of the comparison cities. In part, this seems attributable to the very long period from 1976 to 1982 when nonsubsidized housing production in the City decreased every year. No other continuous period of increases or decreases in output of equal length occurred. Whether this was associated with the onset of rent stabilization cannot be determined from this data alone. In order to examine the issue of the effect of rent stabilization, it is necessary to go beyond the construction data itself, to explore its relation to other factors that were at work during the period.

RENT STABILIZATION AND NEW CONSTRUCTION

The question of the effect of rent stabilization on new construction is analyzed in two ways in this chapter. First, we examine carefully the question of whether there is any difference in the behavior of Los Angeles and the comparison cities during the period when rent stabilization came into being. Secondly, we employ more complex statistical methods to address the question of whether other things that were happening in the housing market might have masked the effect of rent stabilization if that effect were relatively small.

Analysis of Los Angeles and the Comparison Cities

The structure of information in this study allows us to examine the behavior of new construction in a framework that will permit a distinction between the periods before and after rent stabilization was instituted, and between Los Angeles and the comparison cities that have not experienced rent stabilization. An effective summary way in which this can be done is by testing whether the differences between Los Angeles and the comparison cities, year by year, varied significantly over the periods before and after rent stabilization was instituted. By taking the difference between the two in each year, we can effectively offset the effects of other extraneous factors that might affect housing production over time but do not act differently between the localities. One such factor is the interest

rate, which has a powerful effect on decisions to invest in housing, resulting in large changes from year to year. Since the interest rate is essentially the same everywhere in the region, it will not affect the difference between two places in the region in any given year. On the other hand, it should be borne in mind that if there were systematic variations between Los Angeles and the comparison cities over the period, such as a change in the relative amount of available land, then observed shifts in new construction differences might be explained by them.

For each year from 1974 through 1984, the difference in new construction of nonsubsidized multi-family housing between Los Angeles and the comparison cities is shown in the first main column of Exhibit 3.6, together with the mean of the differences in the periods before and after the institution of rent stabilization in 1978-1979. Los Angeles produced substantially more housing during each year than did the comparison cities, but the average annual difference fell from 5058 in the five years from 1974 through 1978, to 3238 in the six years that followed. If it were not for the sharp increase in 1984, the latter number would be even smaller.

EXHIBIT 3.6

Analysis of Differences in New Construction Between Los Angeles and Aggregate Comparison Cities

Los Angeles Minus Comparison Cities

Year	Unsubsidized	Condominium
Pre-Rent Stabilization		
1974	3050	2046
1975	3131	922
1976	7201	1087
1977	6757	3199
1978	5153	4102
Mean value	5058	2253
Post-Rent Stabilization		
1979	2926	3839
1980	2274	4023
1981	1517	2926
1982	1301	705
1983	3675	91
1984	7732	(39)
Mean value	3238	1924
Difference Test		
	T Value = 1.40	T Value = 0.353
	P Value = 0.098	P Value = 0.366

Source: Computed from new construction data.

On the face of it, there is a substantial difference in relative production of housing between Los Angeles and the comparison cities before and after the adoption of rent stabilization. Nonetheless, we should be cautious. There are only eleven years of data upon which to test the question of whether the observed difference might have occurred by chance. In order to test this question, we have used a standard difference test that is reported at the foot of the column in Exhibit 3.6. It shows a probability of 9.8

percent that such a difference might have occurred by chance. Such a value would be ambiguous in conventional statistical terms. However, in a policy context it should not be concluded that there is no effect. Rather, the pattern of differences suggests that there may indeed have been a perceptible relative shift in construction in Los Angeles in the immediate period of rent stabilization. But that shift has become virtually undetectable as developers have adjusted to the existence of regulation and whatever increased level of risk of future control that it entails. This is the behavior that would be expected on theoretical grounds as the market reacts to the existence of a new form of risk, if the perceived level of risk does not change or declines after it is first detected.

As a further check, it is reasonable to ask whether a similar pattern of change may be observed in a form of housing that would not be subject to rent stabilization, namely condominiums. Annual differences in condominium production between Los Angeles and the comparison cities are shown in the right hand column of Exhibit 3.6. Again, there is a fall in the mean value of the difference from the pre- to the post-rent stabilization period. However, the relative drop is much smaller and clearly not statistically significant. More importantly, the average masks a relative rise in Los Angeles condominium construction in the immediate years after rent stabilization, followed by a very sharp relative drop in 1983-1984. In conjunction with the

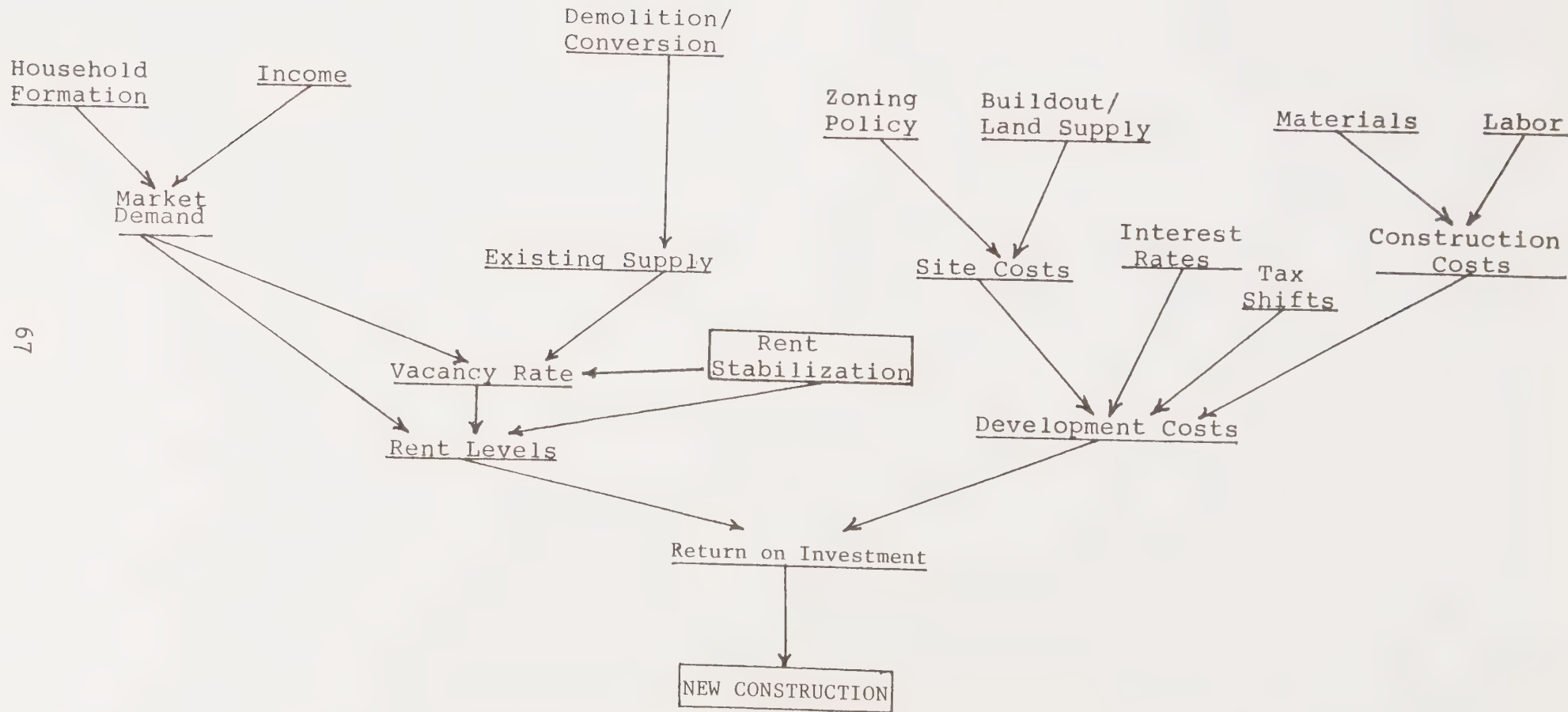
sharp relative rise in nonsubsidized multi-family rental housing in 1984, this does seem to support the contention that the market has by this time essentially discounted the impact of rent stabilization in terms of risk.

Although the analysis in this section provides useful insights into the way in which rent stabilization may have affected the market, it does not address the difficult question of what has caused the changes in production that we observe. For that purpose, we must go beyond the new construction data and ask whether it is possible to isolate effects of rent stabilization as opposed to other factors. For this purpose, more complex statistical methods are required.

Factors Influencing New Construction

The decision by a developer to invest in construction of rental housing is subject to high levels of risk and uncertainty. The demand for rental housing must be projected for a year or more into the future, and by the time the housing is built, demand may have changed because of many factors. For the developer, the central question is whether projected rents in a building or project will be realizable in the market and will cover the costs of development and provide an acceptable level of return on capital invested. Whether this is so depends on factors that affect both demand and cost. Among such factors may be rent stabilization, but its effects on returns and the

EXHIBIT 3.7



investment decision can only be assessed in conjunction with other factors that affect the market during the time that it is implemented.

What are the influences that affect housing markets? Exhibit 3.7 sets out the variables that most analysts regard as important for housing investment decisions. Return on investment in housing is broadly affected by two groups of variables, those affecting supply, and those affecting demand. On the supply side, costs of housing development and operation are subject to four categories of factors: costs of sites and development, construction costs, interest rates, and tax treatment. Costs of buildable land are affected by its aggregate supply and by public policies reflected in zoning and land use regulations. As cities develop, the price of the remaining land tends to rise, other things being equal, forcing up the cost of housing that is built on it. Such effects may be exacerbated by regulation of the scale and nature of development for other reasons. Construction costs are affected by a wide range of factors, many of them related to general business cycle conditions. During times of boom, both labor and materials costs generally rise as demand outruns supply. Interest rates, the cost of money, are especially important for major capital goods such as housing, which require large amounts of capital during construction and to finance the purchase of buildings over a long time period. Finally, tax structures affect profitability through the treatment of

depreciation of capital assets as a cost for tax purposes, and through the deductibility of interest. Although some of these factors may change in concert, others, such as tax structure, tend to change unpredictably. If we seek to account for changes in new construction during a given time period, all must be considered.

The influence of rent stabilization on the cost side of the investment decision is likely to be relatively modest. For the most part, these variables are shaped by other market forces. The cost of building and operating housing of a given quality level should be largely independent of the rent that it can command under varying market conditions.

The predominant effect of rent stabilization should occur through the revenue side of the decision to build, for it is upon rents and revenues that stabilization is focused. A building's projected rent level will depend, in market terms, on the level of demand for space and the competing supply of housing, both existing and new. Over the long-term, demand is established by household formation and income, in conjunction with the general preferences of the population in regard to housing. Shifts in any of these may occur as a result of wider economic, demographic, and social changes. For example, a market experiencing high levels of in-migration of households should exhibit rising demand for housing most suited to their incomes and tastes. Similarly, a market in which incomes are rising will experience shifts

in demand towards higher quality housing, and may also see new household formation as people decide to live apart from others once they can afford to do so.

Demographic and income changes may lead to rising or falling rent levels as they impact on the existing supply of housing. In a well-functioning market, such changes would be expected to act in the short-run through the medium of the vacancy rate on rent levels, leading to changes in the level of revenues generated by buildings. If, for example, demand rises, rents should rise and vacancy rates fall in the short-term, making the operation of rental housing more profitable and increasing the rate of return on investment. In the longer-term, however, higher than average returns in rental housing should attract capital investment into the stock in the form of new construction. The resulting increase in supply should stimulate competition, reducing rents and raising vacancies to the point where rates of return fall to levels comparable to those in other investments of equal risk.

This scenario, or its converse, may be interrupted in many ways. Supply response may be impeded by lack of buildable sites or by regulations intended to prevent changes in environmental or neighborhood conditions. Similarly, rent stabilization is a form of intervention that may prevent revenues from rising in response to increased demand, thereby limiting the incentive to invest in new housing stock. For this reason, most ordinances exempt

newly constructed housing from rent regulation. However, it is widely argued that the existence of regulation exerts a chilling effect nonetheless. On the other hand, by ensuring that vacancy rates remain low, rent stabilization may also act to increase rent levels in housing that is exempt from regulation above the levels that they would realize in an unregulated market. This impact has not been investigated extensively, but could make new construction in fact more attractive than would otherwise be the case.

Housing market adjustments are rarely smooth or uniform in their effects. Construction of new housing has long been subject to a boom and bust cycle. Unable to estimate future demand and supply accurately, developers overbuild in boom periods, only to find themselves with excess stock and falling rents when the cycle changes. The resulting losses lead at first to sharp reductions in new construction, and eventually to steep rent increases as demand continues to grow. Such an adjustment process does not distribute gains and losses equally among developers or tenants. Tenants in areas of highly concentrated demand may find themselves faced with rising rents to the point of being forced to move. If the housing stock is undergoing physical replacement in the process, such neighborhood shifts may be permanent. Thus, the adjustment process may mean community transformation, even if supply works to provide housing through new construction and the filtering by which older housing is passed down to lower income groups.

Estimating Impacts of Rent Stabilization on New Construction

The type of dynamic adjustment process with multiple causal variables described above is hard to model. We would need data on each variable that is accurate and available over time in order to estimate a multi-equation system with appropriately lagged variables. In practice, there is insufficient data to permit the estimation of a complex model for Los Angeles and the comparison cities. We are constrained to work with what is now available, and therefore assess the impact of rent stabilization on new construction through single equation models that do not replicate the full dynamics of the market. However, these models are variants on the reduced form of more complex systems.

The approach that is used draws on the preceding argument to suggest variables that should control for influences other than rent stabilization. Pooled time series and cross-section data are employed for Los Angeles and the comparison cities. In order to account for the variety of factors affecting new construction, we have developed a series of models based on equations of the following general form:

$$X = f(S, I, L, Z, T, V, R) \quad (1)$$

where:

- X = New Construction
- S = rent stabilization dummy variable
- I = interest rate
- L = land availability variable
- Z = regulation variable
- T = tax treatment dummy variable
- V = vacancy rate
- R = rent level variable

Ideally, each variable would be measured for each city (Los Angeles and the comparison cities) for each year from 1974-1984. Unfortunately, specific data for individual cities is not available for all variables. For the interest rate, this is not a major problem because little real variation would be expected from place to place within the region in any given year. For rent levels, however, this is a serious gap.

Information for each of the variables above was collected for each city over the eleven year period. Exact information was not available for every variable in each instance. For land availability, we have used the proportion of land zoned for multi-family residential use that is currently vacant. Multi-year data is not available. The regulation variable is a weighted index based on six factors: number of permits required, time for processing, fees, setbacks required, parking required, the ratio of single to multi-family zoned land, and an index of other factors. Measures on each of these were combined into a single index for each city. Again, multi-year data could not be developed. Interest rates are annual averages for first mortgages in the region. Vacancy rates are estimates developed by the U.S. Department of Housing and Urban Development and the Federal Home Loan Bank Board. Methods used to construct all these estimates are described in the Appendices. The variables for rent stabilization and for tax treatment were dummies. Rent stabilization was assigned

the value of one for Los Angeles in the years 1979-1984, and zero in other years for Los Angeles and in all years for the comparison cities. Thus, its effect was hypothesized, in the first instance, to be equal in every year during which it was in effect. The tax variable was assigned the value of one for all cities in the years 1982-1984, after passage of the 1981 Economic Recovery Tax Act, and zero in all other years. Both rent stabilization and tax variables were also modified in ways discussed below.

The combined time series, cross-section nature of the data permitted two sets of models to be estimated. Aggregate models employed data for Los Angeles and the combined comparison cities over the eleven year period. Thus, there were 22 observations in all. Disaggregated models used Los Angeles and the comparison cities separately, which allowed 77 observations over the period. A number of alternative models were run in each case, using the covariance pooled time series cross-section model estimated by ordinary least-squares.

In summary, then, the aim of this effort was to construct a set of equations that would quantitatively describe the effect of each of the variables on new construction. The parameter of each variable provides an indication of the direction of the effect, its size, and whether it is statistically different from zero. For example, the expected direction of the rent stabilization variable should be negative if stabilization does inhibit

new construction. Similarly, the interest rate should have a negative effect, as higher rates discourage new construction, but the tax variable, reflecting the 1981 Economic Recovery Tax Act, should show a positive effect.

The results of this analysis were uniform in one respect. In no model did the estimated parameter of the original rent stabilization variable exhibit a value that was negative and statistically significant. Other variables, for example, interest rates and vacancy rates, did perform as expected in general, although in some instances the effect of multicollinearity and other problems generated parameters with signs opposite to what was expected. Although it is not possible from this evidence to discount the effect of rent stabilization unequivocally, there is very little likelihood that its influence was as strong over the entire period during which it was in effect.

An example of an aggregated model is exhibited in Exhibit 3.8. The three columns of the table show respectively regression coefficient, standard deviation, and t-value for each variable in a model in which the dependent variable is new construction of unsubsidized units divided by population. This standardization is used for reasons of convenience in recording the data and computing the model. The key points to note in Exhibit 3.8 concern less the

EXHIBIT 3.8

New Construction Model: Aggregate Data

Model 1:

Independent Variable--Unsubsidized New
Construction/Population

Dependent Variables	Regression Coefficient	Standard Deviation	t-value
Constant Term	4.0950	1.2920	3.17
City Dummy	-0.8197	0.2276	-3.60
Rent Stab. Dummy	-0.0626	0.5916	-0.11
Vacancy Rate	0.0079	0.1451	0.05
Interest Rate	-0.4232	0.1083	-3.91
Rent Level	0.012446	0.004096	3.04

$R^2 = 0.715$ $N = 22$ $D.F. = 16$
Adjusted $R^2 = 0.626$
Durbin-Watson = 1.99

precise values of the regression coefficients than their signs, which indicate the direction of their effect on new construction of unsubsidized housing, and the t-values in the right-hand column. In each instance, the signs of the variables correspond to the effects that we would expect from theory and from other analyses. However, in the cases of the variables for rent stabilization and vacancy, the very low t-values indicate that it is very unlikely that the coefficients differ in fact from zero. In other words, this model can show no effect of these variables measured in the form that we have used. While this may seem surprising in the case of the vacancy rate, in fact the only measure of vacancy rates available over the full time period does have some serious deficiencies. The tax variable was excluded

from this particular model. However, in no instance was it possible to detect a significant effect in its original form. In the case of the rent stabilization variable, the evidence from this and other models, both aggregate and disaggregate, suggests that any effect is not detectable by a variable that assumes the same impact in every year in which rent regulation is in effect. Indeed, economic theory would indicate that once the regulation has been implemented, if there is no further real or perceived change in its rigor or in its treatment of new units, then the market should tend to discount the risk in calculating expected returns to investment.

To test this proposition exactly would require a much longer time series than is available for this study. With such a series, it would be possible to construct an ARIMA model of the impact of the rent stabilization intervention and estimate how the impact changed over time. However, we can approximate such a test by postulating that the effect of rent stabilization will diminish over time and viewing the resulting effect in a regression model. In this instance, rather than asserting that the effect of rent stabilization is identical in each year following its adoption (i.e., a dummy variable value of 1 in each such

year), we assume a declining level of effect over time that takes the following form:

Year	Dummy Variable Value
1979	1.0
1980	0.9
1981	0.7
1982	0.5
1983	0.3
1984	0.1

If this variable is inserted into the model in the place of the simple binary rent stabilization variable, the coefficients that result will indicate whether it fits the data better than the previous form. The results of such a model are exhibited in Exhibit 3.9.

EXHIBIT 3.9

Modified New Construction Model: Aggregate Data

Model 2:

Independent Variable--Unsubsidized New Construction/Population

Dependent Variables	Regression Coefficient	Standard Deviation	t-value
Constant Term	4.2130	0.9376	4.49
City Dummy	-1.0481	0.2636	-3.98
Mod. Rent Stab. Dummy	-0.7358	0.4985	-1.48
Vacancy Rate	-0.0547	0.1400	-0.39
Interest Rate	-0.36875	0.08834	-4.18
Rent Level	0.010562	0.003464	3.05

$R^2 = 0.749$ $N = 22$ $D.F. = 16$
 Adjusted $R^2 = 0.670$
 Durbin-Watson = 2.11

If the results in Exhibit 3.9 are compared to those in Exhibit 3.8, it is evident that most of the regression coefficients have changed little in response to the

redefinition of the variable for rent stabilization. The city dummy, interest rate, and rent level variables exhibit coefficients that are correctly signed and statistically significant. The vacancy rate variable is still not significantly different from zero. However, for the new rent stabilization variable, the coefficient is now larger, negative in sign, and approaching a normally acceptable level of statistical significance. The value of the coefficient of multiple correlation, R , has also increased. These indicators suggest that the modification of the model does improve its power to explain the pattern of variation in new construction that is observable in the data. They do not unequivocally lead to the conclusion that rent stabilization did have a short-term effect in precisely the form that was suggested. Nonetheless, they do seem to support the view that it has had some impact, and that the level of impact has decreased over time. If this view is accepted, then it follows that maintenance of confidence on the part of developers rests on their perception of the stability of the rent stabilization system as much as on its specific rules.

Finally, the effect of the 1982 tax reform was reconsidered by assuming that its impacts should be detectable only in 1983 and 1984, that is, at least a year after passage of the ERTA. For technical reasons, this required removal of the general rent level variable, which was very highly correlated with the tax dummy. Exhibit 3.10

shows that with the modified rent stabilization variable in place, the ERTA tax change can indeed be associated with a significant positive impact on rental housing. However, there remains some ambiguity about the relative influence of the tax change as against the general role of high rents in the area in providing incentives for new construction. In this model, the impact of rent stabilization remains essentially unchanged and close to normal levels of statistical acceptability. Thus, although the tax code change has most likely stimulated rental housing construction in recent years, the diminishing effect model of rent stabilization still appears most credible.

EXHIBIT 3.10

New Construction Model with Tax Variable: Aggregate Data
Model 3:

Independent Variable: Unsubsidized
New Construction/Population

Dependent Variables	Regression Coefficient	Standard Deviation	t-value
Constant Term	3.6465	0.7250	5.03
City Dummy	-1.0551	0.2972	-3.55
Mod. Tax Shift Dummy	0.8406	0.3246	2.59
Mod. Rent Stab. Dummy	-0.7421	0.5378	-1.38
Interest Rate	-0.1618	0.0686	-2.36

$R^2 = 0.654$ $N = 22$ $D.F. = 17$
Adjusted $R^2 = 0.573$
Durbin-Watson = 2.05

RENT STABILIZATION POLICY AND NEW CONSTRUCTION

The principal conclusions to be drawn from this analysis are that rent stabilization has impacted construction of new rental housing in Los Angeles, but that impact has been modest and has diminished over time. It should be emphasized that these outcomes refer only to the specific situation of Los Angeles, especially the moderate form of rent stabilization that the City has adopted. There is no hard evidence on the impact of more severe forms of rent regulation on new housing construction.

Two arguments flow from these conclusions. First, the effect of rent stabilization on new housing development depends not only upon the rigor or moderation of regulation, but also on the predictability of the regulatory structure, that is, its propensity to change. Second, rent stabilization policy insofar as it concerns effects on new construction, should take these characteristics into account.

The diminution of impact over time is predictable, but has not been discussed in the literature on moderate rent stabilization. If newly constructed housing is not subject to regulation in a market that has very low vacancy rates and rising incomes, such construction would, on the face of it, present good opportunities for investment, especially at the upper end of the market. The evidence in the HRS&A report suggests that recent movers, who include a

substantial proportion of renters with incomes above the median, will pay a rental premium in a rent stabilized market. The principal inhibiting effect of rent regulation on new construction in such a market is the fear that it may be extended to new housing at some future time. If that does not occur within some years, then the fear may be expected to diminish and the probability of future regulation to be discounted in the market. Something like this appears to have occurred in New York City through the 1950's and 1960's, even though rent regulation was strict in form. In Los Angeles, with its relatively moderate form of regulation, the process may have been faster. By 1984, the inhibiting effect of rent stabilization was undetectable.

If this analysis is correct, then it has several implications for policy. First, substantial changes in the structure and stringency of rental regulation should be made infrequently and with due attention to their potential effects on construction of new rental housing. Maintenance of predictability both in the structure of the rent stabilization ordinance and in its administration are likely to be important signals to the market that investment will be profitable.

Second, if further incentives for private rental housing construction are desired, they may take the form of subsidy, for example, through tax exempt bonds, or they may be sought by reinforcing the confidence of investors that new rental housing would not be rent stabilized at some

future time. An attempt to do this by amendment of the City Charter failed in 1980. However, a similar result might be attainable through the execution of contractual agreements between the City and developers, especially where some clear public purpose such as construction of moderate rent units can be shown. At this time, the necessity for such a policy tool does not appear to be great. However, in the future, it might be a valuable component of housing policy. The legal questions involved are clearly beyond the scope of this report.

CHAPTER 4

MAINTENANCE AND REINVESTMENT IN THE RENTAL HOUSING STOCK

Among all the potential consequences of rent stabilization, perhaps the most frequently debated are its effects on housing maintenance and reinvestment. This concern is not misplaced. The importance of maintenance and reinvestment for sustaining an adequate housing stock can hardly be overstated. Housing is the most difficult of all consumer goods to increase in quantity or to replace if it is lost for any reason. It is costly, long-lived and takes considerable amounts of time to produce. In any given year, no more than one to two percent of the stock can be added under normal circumstances.

With reasonable maintenance and reinvestment in major subsystems, such as roofs or heating, most housing will last at least fifty years, and may be used almost indefinitely. As housing ages, however, it commands a lower price because it is depreciated and obsolescent, and thus becomes an important source of shelter for lower income groups in the population. But without maintenance and reinvestment, housing, like any other capital asset, may become unusable. For want of a relatively modest cost, its entire value may be lost. From this point of view, the housing stock of a community is a valuable social resource that should be treated with due attention in relation to any policy proposals or changes that might be expected to affect it.

This chapter explores the available evidence on the impacts of rent stabilization on housing maintenance and reinvestment in Los Angeles. Of all impacts, these are probably the most difficult to identify and measure with precision. Thus, the analysis must often rely on indirect indicators rather than on directly measured information. Nonetheless, the importance of the subject is such that no policy analysis of rent stabilization would be complete without an attempt to gauge these impacts to the extent that is possible. The chapter is structured in two parts. First, we consider the issue of maintenance, and second that of reinvestment.

RENT STABILIZATION AND MAINTENANCE OF HOUSING

Housing maintenance is easy to understand intuitively, but very difficult to measure without using extremely costly methods. While almost anyone can recognize housing deterioration, finding an easy and economical way to measure it has resisted many attempts, including those of the U.S. Bureau of the Census.

Maintenance in rental housing may be defined as the short-term utilization of resources in order to sustain the level of quality that a housing unit or building provides. It may take many forms, for example, promptly fixing leaks before major damage occurs, regular cleaning of public areas, or removal of trash at frequent and regular intervals. Maintenance is an important determinant of the quality of a housing unit. Together with the initial nature and quality of construction, the age and

obsolescence of the unit or building, and the services that are provided, it defines the overall quality of housing that a resident will experience. Within a given neighborhood or housing submarket, the housing quality of a unit in competition with other units will determine the rent that it can command. Thus, maintenance is a part of the cost of operation of rental housing that directly affects both the quality of the housing for tenants and the income that it generates for owners.

Maintenance and Rent Stabilization

From an owner's perspective, maintenance is a cost that may be varied more easily than most others, such as taxes, interest payments, utilities or insurance. It is the cost element that is most directly controllable at the owner's discretion. In an unregulated rental market, an owner's decision about the level of maintenance to be provided should reflect a judgment about the rent level that a unit of a given size, quality and location will potentially command. Rent minus operating costs and mortgage payments defines the short-run cash flow and the pre-tax rate of return on the unit. Maintenance affects both sides of this equation. Thus, it is a manipulable variable that an owner may use to respond to market shifts in order to maintain or enhance the profitability of a building. If, for example, an owner senses that incomes in an area are rising, then upgrading the maintenance of a building may attract tenants willing to pay higher rents and generate higher rates of return. Conversely, if incomes in an area are falling, a housing unit may no longer

command the same rent level as before. In order to sustain cash flow, the owner may have few short-term means other than reducing maintenance or service levels. In both instances, an owner may also adjust in the longer term through major reinvestment or disinvestment in the building, but the initial response is most likely to occur through changes in maintenance or services.

If this description of the nature and role of maintenance expenditures is accurate, then the impact of rent stabilization on maintenance should occur as a result of pressure on rent levels. If rent levels are maintained by stabilization below the market, and if costs rise, owners may be able to maintain cash flow and rates of return by reducing maintenance. In effect, they would be reducing the real quality of housing supplied so as to reflect its reduced real price. This is essentially the logic that is used in most economic arguments that assert that rent regulation will tend to result in reduced maintenance.

It has also been argued that if rent stabilization sustains a rent level at which demand consistently exceeds supply, owners may also be able to reduce maintenance levels because they no longer have an incentive to keep vacancy rates acceptably low. This is an alternative formulation of the argument above, differing only in the circumstance where net operating income is not reduced by rent stabilization, that is, where rent levels are not significantly lowered by regulation although their rate of increase may be curbed. Under conditions of high demand, this may be possible. In effect, rent stabilization would hold rents

below market levels, but their rate of increase would nevertheless exceed that of costs. Owners could increase returns under these circumstances by reducing maintenance without risking vacancies. Indeed, their perception that demand would allow them to push rents still higher were it not for regulation, may induce them to seek out such alternative methods of increasing the rate of return.

A full analysis of rent stabilization impacts should attempt to elucidate the extent to which changes in maintenance following the implementation of regulation conform to the possibilities suggested above. In practice, such an analysis has never been possible because of the data that it would require. Instead, we must use such indicators as are available to describe the nature of the changes that have occurred in Los Angeles in recent years, and rely on partial means to suggest the nature of the causes that are involved.

Changes in Indicators of Maintenance

Since it is not possible to measure maintenance directly, we must turn to indirect means. The 1984 Rental Housing Study has generated information related to maintenance from five principal sources:

- o Landlord survey
- o Franchise Tax Board
- o Institute for Real Estate Management (IREM)
- o Tenant survey
- o U.S. Census American Housing Survey

The first three of these provide owner-reported information; the last two are based on tenant interviews. They permit generation of two types of information related to maintenance that can throw light on the question of the impacts of rent stabilization. The first type of information is the assessment of changes in indicators of housing quality by residents. If housing quality has declined in people's perceptions, that is a strong though not certain indicator that maintenance levels have also declined. The relation is not absolute, since perceptions may be in error. But the presumption that people can recognize such changes is not unreasonable if it is statistically supported.

The second type of information consists of reported expenditures on maintenance generated at intervals by surveys of owners of buildings. Such information may be reported in dollar terms or as a proportion of total operating costs. In either case, shifts in maintenance expenditures should show up, although the magnitude of the shifts may differ depending on the form of reporting that is used. We shall use both quality assessments and expenditure data in the following discussion.

The available data sources provide assessments of housing quality by tenants in two forms: specific indicators and levels of satisfaction. In the first instance, tenants may be asked to report whether specific deficiencies exist in their housing. Comparisons of surveys at different times or between stabilized and non-stabilized communities then provide an indication of

whether housing quality has changed. The tenant survey conducted by HRS&A contains questions that match those asked on the 1977 American Housing Survey for tenants in Los Angeles and in the six comparison cities.

Exhibit 4.1 summarizes the responses of tenants to questions concerning three items related to maintenance, together with an estimate of the total proportion reporting units in need of repair for Los Angeles and the comparison cities over the period 1977-1984.

EXHIBIT 4.1

Housing Quality Indicators Related to Maintenance (Proportions of Respondents Reporting)

	Los Angeles		Comparison Cities	
	1977	1984	1977	1984
Housing in Need of Repair	12.5%**	15.6%**	4.8%**	15.9%**
Incomplete Plumbing	1.4	0.6	0.7	1.4
Inadequate Heat	10.8	10.0	3.1**	10.2**
3 or More Minor Defects	1.6**	7.0**	1.3**	6.1**

Sources: 1984 HRS&A Tenant Survey; 1977 U.S. Annual Housing Survey

Notes: **Differences between 1977 and 1984 are statistically significant at the 99% confidence level.

Although the table suggests that the quality of housing may have declined over the period 1977-1984, the extent of decline is much greater in the non-rent stabilized comparison cities than in Los Angeles. In both areas, the overall percentage reporting

their housing in some need of repair rose to over 15 percent. Similarly, the incidence of three or more minor defects, a possible indicator of deferred maintenance, increased from less than two to over six percent. The only substantial difference between Los Angeles and the comparison cities occurred in the case of inadequate heat, but that shift was much greater in the comparison cities than in Los Angeles where the incidence fell. The decline, however was not statistically significant.

Although, there appear to have been changes in physical quality of housing over the period in which rent stabilization was implemented, those changes cannot be attributed on this evidence to rent stabilization. This perspective is reinforced by the results of survey questions on the general satisfaction of tenants with various aspects of the quality of their housing. Exhibit 4.2 reports the percentage of respondents in the 1984 tenant survey who expressed general satisfaction with a number of indicators of housing quality. Satisfaction, in this instance, means that the tenant response was either "very satisfied" or "somewhat satisfied" in relation to a given indicator.

EXHIBIT 4.2

Tenant Satisfaction with Aspects of Housing Quality

Quality Indicator	Percent Satisfied	
	Los Angeles	Comparison Cities
Physical Condition	79%	80%
Upkeep	77	77
Speed of Repair	70	72
Landlord	75*	81*

Source: 1984 HRS&A Tenant Survey

Notes: * Difference is statistically significant at the 90% confidence level.

Virtually no difference exists in satisfaction levels between Los Angeles and the comparison cities in relation to these items related to maintenance. The only variable for which a statistically significant difference can be detected is the tenants' attitude toward their landlords, for which satisfaction in Los Angeles is distinctly lower. Unfortunately, no comparable questions to these were asked in the 1977 Annual Housing Survey, so it is not possible to say how these perceptions might have changed in the period during which rent stabilization was in existence. However, for rent stabilization to have had a negative effect on quality strong enough to show up in tenants' perceptions, the level of satisfaction would have had to have been much higher in Los Angeles than in the comparison cities at the earlier date. That is a very unlikely possibility.

If no aggregate impact on maintenance can be detected, it is still reasonable to ask whether such an impact might not have occurred for specific groups at a scale that could not be revealed in the total. Exhibit 4.3 presents information on the level of satisfaction of tenants in Los Angeles and the comparison cities broken out by length of tenure. It has been argued in the Volume on Impacts and Alternatives of this report that length of tenure is one of the most critical variables affecting the impact of rent stabilization benefits for tenants. If that effect also applies to owners' return, then an impact on maintenance and housing quality might also be expected. In fact, Exhibit 4.3 does show some significant differences, but they are not entirely in the direction that we might expect.

From the HRS&A report, we understand that the tenants most likely to benefit from lower rents due to rent stabilization are those whose tenure predates the implementation of the system. For units with such tenants, landlords receive substantially lower rents on average than would be realizable in an unregulated market. Thus, they would have an incentive to reduce maintenance in order to increase their net incomes. If this were the case, tenants would experience dissatisfaction with the physical conditions in their housing despite the low rents.

EXHIBIT 4.3

Tenant Satisfaction with Housing Quality: By Length of Tenure

Quality Indicator	Length of Tenure (Years)			
	<1	1-2	3-5	>6
	Los Angeles: Percent Satisfied			
Physical Condition	85%	80%	79%	75%
Overall Upkeep	83	78	77	73
Speed of Repair	76	69	69	67
Landlord	85	79	82	74
	Comparison Cities: Percent Satisfied			
Physical Condition	92	79	71	79
Overall Upkeep	89	72	75	79
Speed of Repair	89	71	70	67
Landlord	89	78	79	76

Source: 1984 HRS&A Tenant Survey

The data in Exhibit 4.3 are consistent with this hypothesis. Satisfaction with physical condition declines with length of tenure in both Los Angeles and the comparison cities, but the decline is much more consistent in Los Angeles. Furthermore, the percentage of satisfied long-term tenants (that is, with tenure of six or more years) is in every case lower or equal in rent stabilized Los Angeles than it is in the six comparison cities without stabilization. The same is true for recent movers to

their apartments (less than one year's tenure). However, for tenants with tenure of one to five years the picture is not clear. Only for speed of repair is their proportion of satisfied tenants lower in Los Angeles, and that by a modest degree.

A tendency for tenants with low rent-to-income ratios to be generally more satisfied with their housing has been reported in other studies. If length of tenure and rent-to-income ratio were correlated, this could be an alternative explanation for the relationship in Exhibit 4.3. Los Angeles tenants with very high rent to income ratios (above 40 percent) are substantially less satisfied than others on all four indicators reported here as shown in Exhibit 4.4. But for those spending less than 40 percent of income on rent no clear trend emerges. However, length of tenure is not highly correlated with low rent to income ratios, because many very low income tenants have lengthy tenure spans. Thus, the observed relationship of the housing quality indicators to tenure appears to be valid.

EXHIBIT 4.4

Los Angeles Tenant Satisfaction with Housing Quality: By Rent to Income Ratio

Quality Indicator	Rent to Income Ratio			
	<.20	.20-.24	.30-.39	>.40
	Percent Satisfied			
Physical Condition	81%	78%	80%	73%
Overall Upkeep	79%	77%	79%	73%
Speed of Repair	71%	66%	69%	59%
Landlord	74%	76%	83%	73%

Source: 1984 Tenant Survey

This data suggests a conclusion that in the aggregate the impact of rent stabilization on maintenance and the quality of housing in Los Angeles has been modest. For those units occupied by tenants with tenure lengthy enough to affect rent levels to a significant degree, there does appear to be some evidence that maintenance has been reduced as might have been expected.

An alternative source of information about maintenance may be drawn from landlords' responses to surveys about the levels of expenditures in their buildings. Again, the data here are imperfect, but they do provide a second and independent means to gain an understanding of maintenance in housing. The HRS&A survey of landlords, together with data from the Franchise Tax Board and the Institute of Real Estate Management, provide data on operating expenditures in categories that are relevant to maintenance though they do not measure it directly. An indicator of pressure on maintenance expenditures is provided by the ratio of operating costs (which include more than maintenance expenses) to gross income in a building. If operating costs are rising more sharply than income, owners will be inclined to reduce their expenditures on maintenance because it is more flexible than other components such as taxes and insurance. On the other hand, if operating costs rise more slowly, then owners will have less incentive to cut maintenance.

Exhibit 4.5 provides estimates of changes in average gross income and operating costs per unit for Los Angeles owners as reported in the survey. The numbers of responses are not large

and the quality of the 1977 data depends on the accuracy of the records on which these estimates are based. Nonetheless, there are good reasons to accept these numbers as reasonable.

EXHIBIT 4.5

Income and Operating Costs for Rental Housing Units

In Los Angeles: 1977 and 1983

Average Values	1977	1983	Percent Change
Gross Income/Unit	\$1,923	\$3,184	66%
Operating Cost/Unit	943	1,283	36%
Net Operating Income/Unit	980	1,900	94%

Operating Cost/Income Ratio	49%	40%
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Source: HRS&A Landlord Survey, 1984

Note: Data reported here include only cases covering both years. The average operating ratio for the entire sample in 1983 was 43%

The most striking features of Exhibit 4.5 is the sharp increase in average net operating income between 1977 and 1983 in contrast to operating costs. Gross income per unit in the sample rose by about 66 percent over the period. However, net operating income increased substantially more, about 94 percent, because operating costs grew at a much slower rate than income. On the evidence of this data, owners were able to avoid the pressure on net operating income that might lead to reduction of maintenance. However, the composition of the change in operating costs reveals one critical factor. In Exhibit 4.6 changes in the components of operating cost are shown to be of two types. On the one hand,

those elements that typically enter into maintenance and management increased on average at much higher rates than gross income. On the other hand, reported taxes (principally, property taxes) actually fell during the period by 45 percent. Inferences from this data must be treated with caution. Nonetheless, it does appear that costs directly associated with maintenance did rise more steeply than income and that pressure on maintenance would have been greater but for the effect of the restraint on taxes brought about by Proposition 13. In fact, during this

EXHIBIT 4.6

Changes in Average Expenditure Per Unit for Selected Components of Operating Costs, Los Angeles, 1977-1983

Cost Component	Percent Change, 1977-1983
Salaries	102%
Utilities	118
Management and Administration	144
Parts and Supplies	92
Contract Maintenance	71
Taxes and Fees	(45)
Insurance	80

Source: HRS&A Landlord Survey, 1984

period, the share of operating expenses accounted for by taxes fell from 38 percent to 15 percent of average costs per unit. Although the rate of property tax increases on buildings that do not change ownership continues to be restrained, transfers of property will tend to erode this tax shift over time as buildings are reassessed on sale. As that occurs, pressure on maintenance may be expected to increase.

Other direct evidence on shifts in maintenance expenditures is not available. However, the other data sources do indirectly support the argument made here. For example, between 1977 and 1983, the average operating cost ratios reported by IREM fell from 45 percent to 38 percent, a change quite consistent with that shown in Exhibit 4.5. Similarly, data from the Franchise Tax Board reveals an average operating cost ratio in 1983 of 41 percent. However, no data for the earlier period is available.

The Institute of Real Estate Management also generates some information on maintenance and repairs. This annual data covers a sample of larger buildings in the Los Angeles region, including an unknown proportion in the City. Although not directly applicable, it can provide contextual information. Buildings in IREM's sample showed an increase in average expenditure per square foot from 19 cents in 1977 to 32 cents in 1982, a 68 percent increase. In contrast, San Diego data showed an increase of 60 percent compared to an average increase of 87 percent in cities of the Western U.S. This suggests that Los Angeles may be at the lower end of the spectrum in the West, but not in California.

The median percentage of operating costs spent on maintenance and repairs in the Los Angeles region also rose from 5.5 to 6.0 percent from 1977 to 1982. Both the size of the shift and the median percentage are large when compared to other cities. In San Diego, the percentage rose from 4.4 to 4.5 percent, and for Western U.S. cities, it fell from 5.1 to 4.7 percent. Although buildings in Los Angeles constitute only a

part of the total, it is highly unlikely that their behavior could have differed from the average by a large amount.

In conclusion, within the limits imposed by available data, there is no indication that rent stabilization has had a major impact on maintenance of the housing stock. It does appear that there may have been a general lowering of housing maintenance quality in the Los Angeles area, but that has occurred both inside and outside the City. There is also some evidence that a maintenance squeeze may have occurred in buildings with numerous long-term tenants. Furthermore, the likelihood exists that the reduction of property taxes due to Proposition 13 has averted much of the pressure on maintenance that might otherwise have occurred.

REINVESTMENT IN THE RENTAL HOUSING STOCK

Reinvestment in the rental housing stock is an important factor in the continued provision of affordable housing. Without the intermittent replacement and upgrading of major subsystems, housing will cease to be functional even if well maintained. But information on the nature and extent of reinvestment in housing is very difficult to obtain. Neither the aggregate level of investment, nor its composition have been measured in the past. Thus, analysis of reinvestment in relation to rent stabilization must use a variety of partial sources of information and attempt to synthesize a coherent picture from them. In this context, it is important that we define our terms carefully and specify how

the relation between rent stabilization and reinvestment is to be conceptualized.

Reinvestment and Rent Stabilization

Reinvestment in housing may be defined as the utilization of substantial amounts of capital on an intermittent basis for two types of purpose: (1) replacement of obsolescent or worn-out subsystems, for example, roof, heating or electrical, necessary for a unit to provide housing services at a given level; and (2) substantial upgrading of the physical quality of a housing unit in order to attract tenants able and willing to pay higher rents than those currently realized. The former case is analogous to maintenance, but it is differentiated in practice because it requires substantial, lumpy capital expenditures and occurs at intervals of at least several years for any subsystem. The latter case reflects a judgement by an owner that a building is located in a housing submarket in which investment would lead to a rent and revenue increase large enough to raise the rate of return on the property by more than the cost of the investment.

The two instances differentiated above often occur together in the process of rehabilitating housing. However, their implications are not identical. Replacement of major subsystems at periodic intervals is necessary for housing to continue to function and provide services at a given level. Investment in such replacements does not necessarily imply that a building will generate higher rents in the market as a result. A prospective tenant is unlikely to be aware of a new roof on an apartment

building. Historically, some owners have maintained sinking funds in the expectation of replacement of subsystems, and set their rents to reflect that expectation. Others periodically refinanced their buildings and used part of the proceeds for this purpose. But in either case, replacement expenditures have to be allowed for. In the absence of replacement, increased maintenance may allow old systems to continue in operation for a while, but eventually the possibility of such a substitution no longer exists.

Rehabilitation and upgrading, on the other hand, are clearly undertaken with the prospect and objective of increasing the net rental revenue of a building. Such an action would only be taken by a rational investor where such an increase is in prospect, that is, where rents may rise to reflect the changing quality of housing services provided. Reinvestment in this form has often been regarded in a positive light, since it tends to improve the quality of neighborhoods and increase tax revenues to local governments. It may also have negative effects, notably displacement of people unable to afford higher rents, a process often called gentrification.

The distinction between replacement and upgrading poses a dilemma for the theory and operation of rent stabilization. A generally held objective of rent stabilization statutes is to maintain the overall quality of the housing stock, which implies that periodic capital replacement should be encouraged. Yet, if this process of rehabilitation and upgrading also responds to

rising demand with higher rents, then it is in conflict with the stated goals of rent stability and protection of tenants from displacement. Since upgrading often requires treatment of an entire building rather than a single unit, it is difficult to carry it out only on units for which rents may be raised without a burden on existing tenants, for example, on vacancy.

Rent stabilization ordinances therefore normally control the reinvestment process, allowing for rent increases to encourage necessary capital replacement of specific desirable improvements, such as the installation of fire warning systems. But these rent increases are constrained to the level of cost incurred by the owner and reflect that cost spread out over a specified life. Ordinances differ with respect to: the allowable improvements; the length of time over which an improvement is amortized into rent; whether the resulting increase is continued indefinitely; and whether such rent increases are granted in addition to or in place of regular, scheduled increases.

The Los Angeles ordinance has a capital improvements provision that is recognized as relatively liberal in comparison with others. Nonetheless, it essentially attempts to encourage replacement without upgrading to levels that would result in major shifts in rental and occupancy characteristics. The ordinance also includes provision for major rehabilitation of units that would result in their removal from rent regulation. However, the levels of capital expenditure per unit are quite

high (\$10,000 - \$17,000 per unit), and the provision has been used in only a small number of instances.

In an unregulated housing market, the level and nature of reinvestment would normally depend on owners' calculations about the potential return from sustaining a building in its current form as opposed to upgrading it or demolishing it in order to use the land for an alternative investment in housing or some other use. In the aggregate, these decisions will be subject to many influences including changes in demand for housing, shifts in relative costs of new construction and rehabilitation, regulations that encourage or discourage one or another form of development, and changes in interest rates and tax rules. Rent stabilization may also affect reinvestment if it alters the potential returns from rehabilitation by holding rents below market levels. However, the extent and direction of the impact on reinvestment at a particular place and time is difficult to estimate. Fully assessing the impact of rent stabilization on reinvestment would require an effort to sort out the relative influence of all the factors noted above. Such an analysis cannot now be done owing to the impossibility of acquiring the necessary data. Instead, we will use available data to focus on the character of reinvestment in Los Angeles since the inception of rent stabilization, with special emphasis on the operation of the existing mechanism for provision of rent increases to support capital improvements.

Reinvestment in Rental Housing in Los Angeles

Information on reinvestment in the housing stock is quite fragmentary. Indications of its nature in recent years may be derived from two sources: (1) records of applications for rent increases under the capital improvements provision of the Rent Stabilization Ordinance; and (2) responses to the landlord and tenant surveys. Unfortunately, no data on reinvestment exists for the period before rent stabilization, nor are data available for the comparison cities. Most of the following discussion is therefore based on the capital improvements provision data.

The Los Angeles Rent Stabilization Ordinance allows for rent increases beyond the standard annual increase in several ways, among them provisions for capital improvements and renovation, and a little used provision for total exemption of units from rent stabilization upon substantial renovation. The capital improvements and renovation provision permits rent increases to reflect the cost of major replacement items and improvements with at least a five year life. A wide variety of items are included, ranging from new roofs to smoke detectors.

Costs are amortized over a five year term and allocated to benefitted units in the form of rent increases over and above any scheduled increase. Unlike some jurisdictions, Los Angeles does not require that increases expire at the end of the five year period, and they become part of the base for future scheduled adjustments. The application process for a capital improvement

requires invoices for work and materials that are reviewed by RSD staff. Although it has been criticized as too complex, in fact, the process is not excessively so in comparison with other governmentally regulated procedures that involve review of expenditures.

Although data has been collected on the capital improvements provision from its inception, a detailed analysis has not been previously attempted. The data that follows is based on a random sample of approximately ten percent of the total cases since 1979. The methodology for drawing the sample is described in Appendix 3.F. Estimates of volumes of activity, in most instances, have been derived by weighting sample estimates according to the proportion of the total population that they represent.

The central issue in reinvestment concerns the level and adequacy of capital investment in the existing stock. Exhibit 4.7 provides an overview of the contribution to that investment that occurs through the capital improvement provision.

EXHIBIT 4.7

Rent Stabilization Capital Improvement Activity, Los Angeles, 1979-1984

Year	Applications	Estimated Approvals	Approval Rate (%)
1979	1,008	850	84.3%
1980	2,195	1,935	88.1
1981	2,854	2,631	92.2
1982	2,857	2,430	85.1
1983	2,412	2,195	89.8
1984	2,684	2,410	89.8
Total	14,010	12,451	88.9

Source: Rent Stabilization Division records; Capital Improvements Sample

Through the six years of the program, applications have averaged 2,335 per year, with the highest level in 1982 at 2,857. After the initial startup, there is no trend in the data. The program has apparently settled down to a level that varies around 2,600 per year. The approval rate has been high, at about 90 percent in most years. On the face of it, this is an accessible program that offers landlords an opportunity to upgrade the quality of their housing.

How much the program contributes to the needed reinvestment in the housing stock becomes clearer when we look at its impact on buildings and units in dollar terms. Exhibit 4.8 shows the estimated total value of improvements approved in each year with the numbers of buildings and housing units affected. Since some buildings were associated with more than one capital improvement application, the numbers are lower than for total applications. It should be noted that the term "building" refers to a single

registration number, which may in fact cover more than a single building under some circumstances.

EXHIBIT 4.8

Capital Improvement Value and Buildings Affected, 1979-1984

Year	Total Value Approved (\$)	Number of Buildings	Average Investment Per Building
1979	\$3,133,228	793	\$3,951
1980	8,089,151	1,726	4,687
1981	10,939,698	2,244	4,875
1982	14,969,359	2,246	6,665
1983	10,297,052	1,896	5,431
1984	12,213,326	2,252	5,423
Total	\$59,641,814	11,157	\$5,346

Source: Estimated from Capital Improvements Sample

In recent years, capital investment through this provision has generated an estimated \$10 million per year. This figure has not changed appreciably, nor has the number of buildings involved, which is around 2,000 per year. Since there are approximately 70,000 buildings registered under rent stabilization, not more than three percent in any year are generating reinvestment capital by this means, totalling about 16 percent of buildings in all. As we shall discuss further below, this is clearly far below the proportion of buildings on which some form of capital improvement or replacement would be expected. The average value of improvements per building is also quite modest, about \$5,300, in any year. However, given the wide variety of improvements that are acceptable, this figure is not unreasonable.

How does this reinvestment affect housing units and rents? In Exhibit 4.9, estimates of the numbers of units affected and the impact on their rents are presented for each year.

EXHIBIT 4.9

Capital Improvements, Housing Units and Rent Impacts, 1979-1984

Year	Number of Units	Average Monthly Rent Increase	Total Annual Value Of Rent Increase
1979	8,400	\$6.22	\$ 626,976
1980	29,199	4.62	1,618,793
1981	24,468	7.45	2,187,439
1982	43,133	5.78	2,991,705
1983	26,274	6.54	2,061,983
1984	25,377	8.01	2,439,237
Total	156,851	6.34	\$11,926,133

Source: Estimated from Capital Improvements Sample

In proportion to the 534,000 units in the rent stabilized stock, the 26,000 units affected per year amount to about five percent of the total. This higher proportion is accounted for by the tendency on the part of owners of larger buildings to use the capital improvements provision relatively more frequently than others. What proportion of total units have been affected throughout the period is uncertain, but the data on the frequency of multiple applications suggest that as much 25 percent of the total may have received at least one capital improvements increase. The average rent increases have changed little over the years, amounting to around \$7 per month. In 1984, this would have been approximately 1.7 percent of the average rent reported in the tenant survey. Although this seems modest, it should be borne in mind that increases may be granted for more than one

capital improvement and each increase is given in addition to the regular rent increase of 7 percent. The total rent increase therefore may amount to 9 percent or more in a given year. Given the degree of variation in these numbers, it will be much higher for some tenants.

The aggregate picture presented above suggests that the capital improvements provision does generate a significant amount of reinvestment in the stock, although it is only a part of the total that is needed. In order to understand its impact, we need to examine how the investment is distributed in two respects. First, we will consider the impact of the program across buildings of differing sizes. Second, we will analyze the types of improvements that it has supported.

The capital improvements provision has tended to attract owners of larger buildings rather than smaller ones. Exhibit 4.10 presents data on reinvestment and rent impacts by size of building. Of the total reinvestment generated, over 67 percent was directed to buildings of 12 or more units. The proportion of units in buildings of this size in the rent stabilized stock is approximately 37 percent. At the other extreme, about 12 percent of total reinvestment went to buildings with no more than 5 units, which account for 21 percent of such units in the total rent stabilized stock. However, the reinvestment in smaller

EXHIBIT 4.10

Reinvestment and Rent Increases, by Size of Building

Size of Building	Percent of Total Reinvestment 1979-1984	Average Investment Per Unit	Average Rent Increase Per Unit/Month
2-5 units	11.82	855	14.26
6-11 units	20.00	464	7.74
12 or more units	67.75	237	3.95
Total	100.00%	\$291	\$4.84

Source: Estimated from Capital Improvements sample.

buildings did take substantially larger values per unit and the rent adjustments were correspondingly greater. In part, this characteristic may be due to the fact that the value of capital improvements must be of some minimum size which does not necessarily increase in proportion to the size of building.

Finally, we turn to the issue of what types of capital improvements have been supported under the program. Over 70 forms of improvement have been identified in the analysis, including major investment items, such as roofs and remodeling, and quite small items such as linoleum. Few have occurred in substantial numbers. Exhibit 4.11 provides information on the four most most frequently requested and approved items. A full listing is provided in Appendix 3.F.

EXHIBIT 4.11

Most Frequent Capital Improvements and Costs, 1979-1984

Capital Item	1979	1980	1981	Year 1982	1983	1984	Total
Roofs							
Applications	522	950	870	652	697	453	4,144
Approvals	413	790	785	510	611	393	3,502
Average Cost	\$2,756	4,778	4,493	5,961	4,662	6,717	4,813
Exterior Painting							
Applications	461	441	562	522	406	406	2,798
Approvals	389	389	517	444	369	365	2,473
Average Cost	\$1,455	4,326	2,222	2,738	3,451	3,684	3,040
Carpeting							
Applications	132	362	308	450	257	728	2,237
Approvals	72	351	234	403	240	716	2,016
Average Cost	\$2,201	982	925	1,027	2,091	1,024	1,273
Hot Water Heater							
Applications	96	226	350	308	280	240	1,500
Approvals	96	158	350	249	257	240	1,350
Average Cost	\$ 482	724	1,143	899	1,320	1,073	1,074

Source: Estimated from the Capital Improvements sample.

The data in Exhibit 4.11 provide a means to gauge the extent to which the capital improvements provision serves the housing stock as a whole. For example, if roofs last an average of 15 years, then about 7 percent should require replacement each year. Although this figure will vary depending on the age of the housing stock and the expectations of owners, it is a reasonable first approximation. With a rent stabilized stock of some 70,000 buildings, we might expect about 4,500 to need renovation each year. On average, the capital improvements program has accounted for some 584 roof improvements each year, or about 13 percent of the estimated need. Few other improvements have expected lives as

long as roofs, yet this is the most frequently requested item. Thus, we may conclude that the provision accounts for an even smaller proportion of total capital investment in other types of improvement. Overall, it seems reasonable to assert that the program probably accounts for less than 10 percent of the capital needs of the housing stock.

Does this mean that reinvestment is not occurring? That seems unlikely in view of the generally favorable picture of maintenance that emerges from the surveys. In addition to questions on maintenance, tenants were also asked whether they had experienced any major improvements since 1978 in their buildings. The answers must be interpreted with care, since major improvement was not fully defined in the question. Nonetheless, over 30 percent responded that such an improvement had occurred, as shown in Exhibit 4.12. As might be expected, the

EXHIBIT 4.12

Percentage of Tenants Reporting a Major Improvement Since 1978,
By Housing Type

	Percent of Responses by Building Type			
	2-4 units	Garden Appt.	Lowrise	Highrise
Major Improvement	34.2%	36.5%	35.7%	45.4%
No Improvement	51.1	54.8	50.3	40.8
Not Sure	14.7	8.7	14.0	13.8
Total	100.0%	100.0%	100.0%	100.0%

Source: HRS&A Tenant Survey, 1984

response varied with rent levels, but even in the lowest category (less than \$285 per month), over 30 percent reported a major improvement. These might be the units least expected to attract improvements. Among higher rent units, the proportion reporting a major improvement was generally lower, except in the case of highrise units, where it increased with rent levels.

Landlords were also asked whether they had made any capital improvements since 1977. About 58 percent of the sample responded. In total, some 30 percent reported that they had made a capital improvement since 1977, with over 12 percent reporting an improvement valued at over \$2,000. In view of the response rate, it is necessary to be cautious in interpretation of this data. However, a reasonable assumption about the pattern of non-response would suggest that at least 20 percent have indeed made capital improvements, and the real number is in all probability substantially higher.

CONCLUSION

The evidence on maintenance and reinvestment in the housing stock is mixed and subject to alternative interpretations. On balance, it is our view that the impact of rent stabilization on both maintenance and reinvestment has been modest. While there is evidence of some decline in the quality of the housing stock overall, it occurs in both Los Angeles and the comparison cities. Rent stabilization cannot be directly associated with this change, with the exception that tenants with either very short or lengthy tenure in Los Angeles do seem to perceive lower levels of

maintenance than those in the comparison cities. Similarly, the pressure on the capital improvements provision of the Ordinance has been relatively mild in view of its relatively accessible character in comparison to other rent stabilization ordinances, although it has played an important role in ensuring that reinvestment would occur.

How have these outcomes been possible in the context of rent stabilization? The clearest answer may be found in the fact that rents have increased fast enough to sustain owners' rates of return and therefore their incentive to reinvest. Most of this reinvestment appears to have been occurring through the normal mechanism of the market. So long as vacancy rates are low and rent levels remain high enough to sustain returns, there is no reason to expect any major change in either maintenance or reinvestment patterns. However, the effect of Proposition 13 in reducing tax burdens has probably been critical in sustaining levels of maintenance. In the long term, increases in maintenance costs will need to continue to be offset by adequate rent adjustments to ensure that owners do not have the incentive to disinvest.

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1984 Rental Housing Study

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